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Clients&FriendsMemo

Securitization Reform Proposals: The Credit Risk Retention Act of 2009 and the Restoring American Financial Stability Act of 2009

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On December 11, 2009, the United States House of Representatives passed the Credit Risk Retention Act of 2009[1] (the "**House Bill**") as part of the Wall Street Reform and Consumer Protection Act of 2009.[2] The House Bill proposes laws affecting transfers of loans and the issuance of asset-backed securities ("**ABS**").[3]

On November 10, 2009, Senator Chris Dodd of Connecticut released a discussion draft of a bill proposing laws to reform the financial system, called the Restoring American Financial Stability Act of 2009.[4] A section of the discussion draft entitled "Improvements to the Asset-Backed Securitization Process" (the "**Senate Proposal**" and, together with the House Bill, the "**Proposals**"),[5] contained an alternative proposal for regulating ABS securitization to the October 29, 2009 draft of the Credit Retention Act of 2009 issued by the House Financial Services Committee.

The Proposals share many of the same provisions regarding securitization reform, but have the following key differences in the credit risk retention requirement:

- the House Bill has a 5% credit risk retention requirement, whereas the Senate Proposal has a 10% credit risk retention requirement (in each case, subject to adjustment or exemption by the applicable regulators);

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1 See The Credit Risk Retention Act of 2009, included as Title I, Subtitle F, to The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173ih.txt.pdf.

2 See The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009).

3 The House Bill is a revised version of a draft released by the House Financial Services Committee on October 29, 2009, which combined the Credit Risk Retention Act of 2009, originally proposed by Representative Walter Minnick of Idaho on March 26, 2009, and Subtitle E: Improvements to the Asset-Backed Securitization Process of the Investor Protection Act of 2009, originally proposed by the Obama Administration on July 22, 2009 as a follow up to its June 17, 2009 release of recommendations for reform of the financial regulatory system.

4 See the Restoring American Financial Stability Act of 2009, discussion draft, 111th Cong. (2009), available at http://banking.senate.gov/public/_files/AYO09D44_xml.pdf.

5 See *Id.* at Title IX, Subtitle D, Improvements to the Asset-Backed Securitization Process.

- the House Bill requires both (1) creditors that originate and transfer loans to third parties and (2) securitizers of ABS to retain credit risk, whereas the Senate Proposal only requires securitizers that transfer assets to third parties through the issuance of ABS to retain credit risk;
- the House Bill allows the appropriate federal agencies to decrease, or exempt creditors and securitzers from, the 5% credit risk retention requirement for loans included in a securitization where a third-party specifically negotiates for the purchase of the first-loss position, provides due diligence on all individual loans in the pool prior to issuance of the ABS and retains a first-loss position (this provision would appear to benefit primarily CMBS securitizers); and
- the Senate Proposal would require disclosure in registration statements filed pursuant to the Securities Act of 1933, as amended (the "**Securities Act**"), of information regarding (1) the assets backing each tranche or class of ABS (including loan-level detail) and (2) information identifying loan brokers and originators, the nature and extent of their compensation and the amount of risk retained by the originator or securitizer.

It should be noted that pursuant to Financial Accounting Statement 167, the existence of a credit risk retention requirement of 5% or 10% for securitizers may cause the securitizations to remain on the securitizer's balance sheet if the securitizer services the assets or has rights that give it the power to direct activities of the securitization vehicle that significantly impact the securitization vehicle's economic performance.

Another difference is that the Senate Proposal would require the Securities and Exchange Commission ("**SEC**") to issue rules regarding registration statements that would require any issuer of ABS to perform a due diligence analysis of the assets underlying such ABS and to disclose the nature of such analysis. The House Bill does not contain a due diligence requirement.

Common elements contained in both Proposals include:

- a prohibition on hedging or otherwise transferring credit risk that is required to be retained pursuant to the Proposals (subject to exemption or adjustment by the applicable regulators);
- a requirement that regulations specify the minimum duration for risk retention;
- continued periodic reporting under the Securities Exchange Act of 1934, as amended (the "**Exchange Act**"), by issuers of ABS even after the number of registered holders falls below 300, at least for such period of time and under such conditions prescribed by the SEC;
- a mandate for SEC regulations requiring:

  (1) disclosure of information regarding the assets backing each tranche or class of ABS (including loan-level detail);

(2) disclosure of information identifying loan brokers and originators, the nature and extent of their compensation and the amount of risk retained by the originator or securitizer; and

(3) standardization of the format of data provided by issuers;

- a mandate for SEC regulations regarding ABS representations and warranties requiring:

(1) rating agencies to analyze in rating agency reports how representations, warranties and enforcement mechanisms of ABS offerings compare to similar transactions; and

(2) disclosure of fulfilled repurchase requests across all trusts aggregated by the originator; and

- repeal of Section 4(5) under the Securities Act, which exempts offers and sales of mortgage notes from the registration requirements under the Securities Act.

Credit Risk Retention

The House Bill

The House Bill would require the appropriate federal agencies[6] to prescribe regulations:

(1) within 180 days requiring "any creditor that makes a loan to retain an economic interest in a material portion of the credit risk of any such loan that the creditor transfers, sells, or conveys to a third party . . ."[7]; and

(2) requiring "any securitizer of asset-backed securities that are backed by assets not described in [clause] (1) to retain an economic interest in a material portion of any such asset used to back an issuance of securities."[8]

"Creditor" is not defined in the House Bill. "Securitizer" is defined as "the person that transfers, conveys, or assigns, or causes the transfer, conveyance, or assignment of, loans, including through a special purpose vehicle, to any securitization vehicle, excluding any trustee that holds such loans for the benefit of the securitization vehicle."[9] The reference in clause (2) relating to assets not

6 The "appropriate federal agencies" mean, with respect to (1) any mortgage insured under Title II of the National Housing Act, the Secretary of Housing and Urban Development, (2) any loan meeting the conforming loan standards of the Federal National Mortgage Corporation or the Federal Home Loan Mortgage Corporation, or an asset issued by either such corporation, the Federal Housing Finance Agency, (3) any loan insured by the Rural Housing Service, the Rural Housing Service or (4) any loan or ABS not covered by clauses (1), (2) or (3), jointly, the Federal banking agencies, the National Credit Union Administration Board and the SEC. See supra Note 1, at § 1502(a), 29(e).

7 See *Id.* at § 1502(a), 29(a)(1).

8 See *Id.* at § 1502(a), 29(a)(2).

9 See *Id.* at § 1502(a), 29(i)(5).

described in clause (1) is unclear, although it appears to be intended to avoid double counting if the creditor under clause (1) is the securitizer under clause (2).

The regulations would require creditors and securitizers to retain at least 5%[10] of the credit risk on any loan that is transferred, sold, or conveyed by a creditor or securitized by a securitizer for a minimum duration to be specified in the regulations.[11] The appropriate federal agencies would be able to decrease, or exempt a creditor or securitizer from, the 5% credit risk retention percentage if:

> (1) the credit underwriting or due diligence meets certain standards prescribed by the appropriate federal agency; and
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> (2) the loan has terms, conditions, and characteristics determined by an appropriate federal agency to reflect loans with reduced credit risk, such as (a) loans that meet certain interest rate thresholds, (b) loans that are fully amortizing, and (c) loans that are included in a securitization in which a third-party purchaser specifically negotiates for the purchase of the first-loss position, provides due diligence on all individual loans in the pool prior to the issuance of the ABS and retains a first loss position.[12]

The appropriate federal agencies would be able to increase the 5% credit risk retention percentage if the underwriting or due diligence is insufficient.[13] Regulations would also require the credit risk retained by a creditor or securitizer to be no less at risk of loss than the average of the credit risk not retained by the creditor or securitizer (e.g., no less at risk than a *pro rata* vertical slice).[14] Regulations would also prohibit creditors and securitizers from directly or indirectly hedging or otherwise transferring credit risk that a creditor or securitizer is required to retain.[15]

The risk retention requirement under the House Bill will not apply to any loan:

> (1) insured, guaranteed or administered by the Secretary of Education, the Secretary of Agriculture, the Secretary of Veterans Affairs, or the Small Business Administration; or
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> (2) made, insured, guaranteed, or purchased by any person subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation.[16]

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10 See *Id.* at § 1502(a), 29(c)(2).

11 See *Id.* at § 1502(a), 29(c)(4).

12 See *Id.* at § 1502(a), 29(c)(2)(A).

13 See *Id.* at § 1502(a), 29(c)(2)(B).

14 See *Id.* at § 1502(a), 29(c)(3).

15 See *Id.* at § 1502(a), 29(c)(1).

16 See *Id.* at § 1502(a), 29(d)(1).

In addition, the appropriate federal agencies may:

> (1) apply the risk retention requirement to securitizers of loans, or particular types of loans, in addition to, or in substitution for, any or all of the requirements that apply to creditors that make such loans, or types of loans;[17] or
>
> (2) provide exemptions or adjustments to the percentage of risk retention required to be held and the prohibition on hedging if such action would (a) help ensure high quality underwriting standards for creditors and (b) facilitate appropriate risk management practices by such creditors, improve access of consumers to credit on reasonable terms, or otherwise serve the public interest.[18]

This provision of the House Bill gives the appropriate federal agencies significant flexibility in apportioning credit risk retention among creditors and securitizers or providing exemptions or adjustments to the risk retention requirement, making it difficult to estimate the impact that the House Bill will have on lending and securitization until the appropriate federal agencies issue implementing regulations.

Requiring creditors to retain un-hedgeable credit risk with respect to loans they originate could significantly impact the transfer of loans to secondary market participants, and therefore the ability of some lenders to lend. The House Bill does not specify the form of risk retention, such as retention of participation interests in the transferred loans or guarantees in a portion of the losses on them. The House Bill also does not specify whether credit risk must be retained on a pool-wide or individual loan basis. If required on an individual loan basis, transaction costs may make the transfer of loans to secondary market participants uneconomical except in the case of large loans. Converting even ordinary residential mortgage loans into loan participations would also, under current SEC staff positions, render the securities backed by those assets ineligible for shelf registration. The inability to sell loans in a secondary market could inhibit the willingness of creditors to originate all types of loans, which could reduce the availability of credit to consumers and businesses.

The Senate Proposal

The Senate Proposal would require federal banking agencies and the SEC to jointly prescribe regulations within 270 days requiring "any securitizer to retain an economic interest in a material portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party."[19] "Securitizer" is defined as "(A) an issuer of

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[17] See *Id.* at § 1502(a), 29(b).

[18] See *Id.* at § 1502(a), 29(d)(1).

[19] See supra Note 5 at § 941(b), 15G(b).

an asset-backed security; or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer."[20] This definition of "securitizer" includes both issuers and sponsors of ABS. It is unclear whether both the issuer and the sponsor in an ABS transaction would have to retain the required credit risk percentage, or whether the retention requirement would be satisfied if either entity retained such credit risk. Since securitizations generally include both an issuer and a sponsor, this provision may cause double-counting of credit risk retention.

Regulations would require securitizers to retain at least 10% of any asset that is transferred, sold or conveyed to a third party through the issuance of ABS[21] and securitizers would be prohibited from directly or indirectly hedging or otherwise transferring such credit risk.[22] Regulations would specify the permissible forms of risk retention (e.g., first loss position or *pro rata* vertical slice) that would be required and the minimum time period that securitizers would be required to retain such risk.[23] Regulations would also provide for the allocation of risk retention obligations between securitizers and originators where a securitizer purchases assets from an originator.[24]

The federal banking agencies and the SEC would be able to grant total or partial exemptions from the risk retention requirement for securitized assets that are guaranteed by the United States, an agency of the United States or a government-sponsored enterprise.[25] In addition, regulations could provide total or partial exemptions for any other securitizations as may be appropriate in the public interest or for the protection of investors.[26] The federal banking agencies and the SEC would also be able to jointly adopt or issue exemptions, exceptions or adjustments to the risk retention requirement and the prohibition on hedging if such exemptions, exceptions or adjustments:

> (1) help ensure high quality underwriting standards for securitizers and originators of assets; and
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> (2) encourage appropriate risk management practices by securitizers and originators of assets, improve the access of consumers to credit on reasonable terms, or are otherwise in the public interest and for the protection of investors.[27]

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[20] See *Id*. at § 941(b), 15G(a)(3).

[21] See *Id*. at § 941(b), 15G(c)(2).

[22] See *Id*. at § 941(b), 15G(c)(1).

[23] See *Id*. at § 941(b), 15G(c)(3)(B).

[24] See *Id*. at § 941(b), 15G(c)(5)(C).

[25] See *Id*. at § 941(b), 15G(c)(5)(A).

[26] See *Id*. at § 941(b), 15G(c)(5)(B).

[27] See *Id*. at § 941(b), 15G(d)(2).

The Senate Proposal for credit risk retention is less burdensome than the House Bill to the lending markets because it applies only to securitizers as opposed to all creditors. However, the 10% credit risk retention requirement may increase securitization costs enough to make securitization uneconomical, which could significantly reduce the availability of credit to consumers and businesses. Like the House Bill, the Senate Proposal gives the federal banking agencies and the SEC significant flexibility in adopting exemptions, exceptions or adjustments to the credit risk retention requirement, making it difficult to estimate the impact that the Senate Proposal will have on lending and securitization until the federal banking agencies and the SEC issue implementing regulations. As previously noted, the credit risk retention percentage in the Senate Proposal was increased to 10% from the 5% requirement proposed by the Obama Administration[28] and the House Bill.

Periodic Reporting by Issuers of ABS

Both Proposals would require continued reporting by issuers of ABS under the Exchange Act for such period of time and under such conditions as prescribed by the SEC, even if the number of holders of an issue falls below 300.[29] In addition, each issuer of ABS would also be required to disclose, at a minimum, asset-level or loan-level data necessary for investors to independently perform due diligence for each tranche or class of security.[30] Disclosure would also be required concerning the:

- loan broker or originator of the assets backing the security;
- nature and extent of compensation of the broker or originator; and
- amount of risk retained by the originator or the securitizer of such assets.[31]

The SEC would also be required to set data formatting standards to facilitate comparison of data across securities for similar asset classes.[32]

The required disclosures described above apply to periodic reports filed pursuant to the Exchange Act and, in the case of the Senate Proposal only, would also apply to registration statements filed pursuant to the Securities Act.

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28 See Investor Protection Act of 2009, Title IX, Subtitle E: Improvements to the Asset-Backed Securitization Process, at § 951, 15F(b)(2), available at http://www.ustreas.gov/press/releases/reports/title%20ix%20subt%20e%20securitization%207222009%20fnl.pdf.

29 See supra Note 1 at § 1503(1); See supra Note 5 at § 942(a).

30 See supra Note 1 at § 1503(3); See supra Note 5 at § 942(c)(2).

31 See *Id.*

32 See *Id.*

Subjecting ABS to the periodic reporting requirements of the Exchange Act for the life of the securities would increase costs associated with securitization because it would require issuers to maintain sufficient infrastructure to provide not only monthly expanded bond-level and loan-level reporting, but also to:

- monitor and report monthly on Form 10-D, and annually on Form 10-K, updated information with respect to (i) significant obligors, (ii) credit enhancement providers, (iii) derivative counterparties, (iv) litigation affecting transaction parties, and (v) affiliations among transaction parties;
- file annual assessments of compliance for each participant in the servicing function and related accountants' attestations under Item 1122 of Regulation AB;
- file annual compliance statements of each servicer under Item 1123 of Regulation AB;
- prepare and file annual "Sarbanes-Oxley" certifications; and
- file current reports on Form 8-K to report specified events, such as amendment or termination of material agreements, change of servicer or trustee, change in credit enhancement, or failure to make a required distribution.

By remaining reporting companies, issuers will become subject to the risk of loss of shelf registration eligibility for failure to timely file Exchange Act reports and will also be obligated to comply with the public disclosure requirements of Regulation FD in the event that material non-public information is provided about the ABS to non-exempt third parties.

Representations and Warranties Relating to ABS Offerings

Under both Proposals, the SEC would be required to prescribe regulations requiring rating agencies to include in reports accompanying credit ratings:

- a description of the representations, warranties and enforcement mechanisms available to investors; and
- a description of how such representations, warranties and enforcement mechanisms differ from those in similar transactions.[33]

The SEC would also be required to prescribe regulations requiring disclosure of fulfilled repurchase requests across all trusts aggregated by originator, "so that investors may identify asset originators with clear underwriting deficiencies".[34]

[33] See supra Note 1 at § 1504(1); See supra Note 5 at § 943(1).

Elimination of Securities Act Section 4(5) Exempting Offers and Sales of Mortgage Notes

Section 4(5) of the Securities Act permits, subject to certain conditions, savings and loan associations, savings banks, commercial banks and other similar banking institutions to sell promissory notes (and participation interests therein) directly secured by a first lien on a single parcel of real estate upon which a dwelling or other residential or commercial structure is located without filing a registration statement under the Securities Act.[35] Both Proposals would eliminate this Securities Act registration exemption.[36]

It is unclear why this repeal has been proposed, as there is no evidence that purchasers and sellers of mortgage loans relied upon this exemption for ABS transactions in any meaningful way. We would not expect the repeal of Section 4(5) to adversely affect the private whole loan mortgage market, which generally involves negotiated sales of pools of loans between sophisticated buyers and sophisticated sellers, although mortgage market participants may have concerns about the intent of the proposed repeal.

Due Diligence Disclosure in ABS Registration Statements

The Senate Proposal would require the SEC to issue rules relating to registration statements filed by issuers of ABS, requiring any such issuer to perform a due diligence analysis of the assets underlying such ABS and to disclose the nature of such due diligence analysis.[37] The House Bill does not contain this due diligence requirement.

Congressional Reports on the Risk Retention Requirement

The House Bill would require the Federal Reserve Board of Governors to issue a report to Congress within 90 days of enactment on the combined impact of (1) the credit risk retention requirements and (2) Financial Accounting Statements 166 and 167 on each individual class of ABS.[38] The report must contain statutory and regulatory recommendations for eliminating any negative impacts on the continued viability of the ABS securitization markets and on the availability of credit for new lending.[39] In addition, the House Bill would require the Chairman of the Financial Services Oversight Council (a new regulatory council to be established by the Wall Street Reform

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[34] See supra Note 1 at § 1504(2); See supra Note 5 at § 943(2).

[35] See 15 U.S.C. § 77d(5)(A) (2006).

[36] See supra Note 1 at § 1505(a); See supra Note 5 at § 944(a).

[37] See supra Note 5 at § 945.

[38] See supra Note 1 at § 1502(b).

[39] See *Id.*

and Consumer Protection Act of 2009[40]) to issue a report to Congress within 180 days of enactment on the macroeconomic effects of the risk retention requirements and other amendments in the House Bill, emphasizing the potential beneficial effects of stabilizing the real estate market.[41] The Senate Proposal does not contain provisions requiring such reports.

Next Step in the Legislative Process

The members of the U.S. House of Representatives approved the House Bill on December 11, 2009. The House Bill will now be sent to the U.S. Senate, which can either approve the House Bill in its current form, approve it with amendments (which must be ratified by the House of Representatives), or disapprove it and proceed with the Senate Proposal, some other proposal or drop the proposal altogether.

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Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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[40] See supra Note 2 at § 1001.

[41] See supra Note 1 at § 1506.