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Clients&FriendsMemo

The Obama Administration's Financial Regulatory Reform Proposal and Its Impact on the Securitization Markets

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On June 17, the Obama Administration released its recommendations for reform of our financial regulatory system (the "**Proposal**")[1], as described in our clients and friends memorandum[2] summarizing the Proposal. This memorandum explains the impact the Proposal would have on the securitization and related markets. Specifically, the Proposal would require:

- Originators or sponsors to retain a material portion (generally 5%) of the credit risk of securitized exposures ("skin in the game").
- Compensation of market participants to be aligned with longer-term performance of the underlying loans.
- Increased and standardized disclosure and reporting requirements for securitization issuers.
- Increased regulation of rating agencies.
- Changes to the over-the-counter ("**OTC**") derivatives market that seek to change what was described as "a lax regulatory regime for OTC derivatives", which would potentially have a substantial impact on the use of embedded derivatives in securitization transactions.
- Many managers of collateralized debt obligations ("**CDOs**"), and potentially collaterized loan obligations ("**CLOs**"), to register under the Investment Advisers Act of 1940 (the "**Advisers Act**").

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1 To view the Obama Administration's white paper, see, http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

2 See http://www.cadwalader.com/assets/client_friend/061709_FinancialRegulatoryReformProposal.pdf.

Risk Retention

The Proposal notes that a significant problem in the securitization markets was the lack of sufficient incentives for lenders and securitizers to consider the performance of the underlying loans after asset backed securities ("ABS") were issued. To address this issue, the Proposal would:

- Require federal banking agencies to issue regulations that require loan originators or sponsors (as determined by the applicable regulator) to retain 5% (subject to adjustment as described below) of the credit risk of securitized exposures.

- Prohibit the originator or sponsor from directly or indirectly hedging or otherwise transferring the risk it is required to retain.

- Provide federal banking agencies the authority to specify the permissible forms of required risk retention (e.g., first loss position or pro rata vertical slice) and the minimum duration of the required risk retention.

- Allow federal banking agencies the flexibility to make exceptions or adjustments to these requirements as needed in certain cases, including raising or lowering the 5% threshold and to provide exemptions from the "no hedging" requirement that are consistent with safety and soundness.

How sponsors and originators are to retain credit risk in securitized assets is not at all clear; nor is it clear how 5% of credit risk is either quantifiable or retainable. Would the originator or sponsor have to hold 5% in the form of the first loss position, a pro rata vertical slice of each tranche or a participation in each loan or would puts, guarantees, or similar credit loss sharing arrangements suffice?

Further, while the logic of this requirement appears sound in theory, in practice, it likely will cause the failure of small mortgage companies that do not have sufficient capital to carry such retained interests. Even for well-capitalized institutions, it is likely that, for some, the cost of retaining an interest in what is sold would eliminate any slim profit margin under which they currently operate. As a result, there could be fewer mortgage originators in the market, which could result in less competition and possibly higher borrowing costs to consumers.

In addition, the recent accounting changes promulgated in FAS 166 and FAS 167, which go into effect later this year, would disallow off-balance sheet treatment for many sponsors and originators, particularly those that service the related loans, if required to retain credit risk in securitized assets. On-balance sheet treatment could make securitization economically not feasible for many sponsors

and originators, which could have the effect of further exacerbating the lack of liquidity in the securitization markets.

Align Compensation of Market Participants with Longer Term Performance of the Underlying Loans

To further address the Proposal's goal of incentivizing lenders and securitizers to consider the performance of underlying loans after the ABS are issued, the Proposal requires that compensation of brokers, originators, sponsors, underwriters, and others involved in the securitization process should be linked to the longer-term performance of the securitized assets, rather than only to the production, creation or inception of those products. Specifically, the Proposal:

- Requires performance-based, medium-to-long term approaches to securitization fees to enhance incentives for market participants to focus on underwriting standards.
    - For example, the fees and commissions received by loan brokers and loan officers, who otherwise have no ongoing relationship with the loans they generate, should be disbursed over time and should be reduced if underwriting or asset quality problems emerge over time.
- Supports changes to Generally Accepted Accounting Principles ("GAAP") that would eliminate the immediate recognition of gain on sale by originators at the inception of a securitization transaction and instead require originators to recognize income over time;

While the compensation proposals may be appropriate, in practice it will be difficult to determine if a loan default occurs due to lax underwriting, changed circumstances of the borrower (e.g., loss of job, divorce, etc.) or changed market conditions.

If the accounting changes are implemented, securitization may no longer be an economically attractive option for many originators. As a result, similar to the impact of the risk retention proposal, there could be fewer originators in the market, which could result in less competition and possibly higher borrowing costs to consumers.

Increasing Transparency and Reporting Requirements of ABS Issuers

The Proposal expresses concern regarding the lack of transparency, standardization and ongoing reporting in ABS transactions. While disclosure requirements for ABS transactions were codified and standardized to a degree with the adoption of Regulation AB in 2005, additional changes to the disclosure requirements, both at the time of the offering and on an ongoing basis will impact securitization transactions. Although the Proposal acknowledges that the industry is working to

standardize and increase transparency and the SEC is also currently working on improving disclosure and standardization, the Proposal highlights specific issues that need further improvement:

- Improving and standardizing disclosure by originators, underwriters, and rating agencies.
- Clarifying the authority of the SEC to require vigorous ongoing reporting by ABS issuers.
- Ensuring that investors and rating agencies have access to sufficient information necessary to assess the credit quality of the assets in an ABS transaction at the outset and on an ongoing basis, including with respect to the credit, market, liquidity, and other risks of ABS.
- Improved disclosure of loan-level data (broken down by loan broker or originator) and type and extent of compensation of brokers, originators and sponsors together with their risk retention, if any, for each transaction.
- Particularly with respect to residential mortgage-backed securities ("**RMBS**"), the institution of clear and uniform rules on a servicer's ability to modify the related loans if appropriate to benefit the securitization trust as a whole.
- Expanding the Trade Reporting and Compliance Engine (TRACE), the electronic trade reporting database for corporate bonds, to ABS.
- Sponsors of securitizations to provide stronger, standardized representations and warranties, regarding the risk associated with the origination and underwriting practices for the securitized loans underlying ABS.

Although many of these proposals are likely to be non-controversial, as the ABS industry has in many respects recognized the need for increased transparency and standardization,[3] these industry-developed standards and practices could potentially conflict with SEC mandated disclosures. It will be important to coordinate industry-led efforts with the efforts of regulators to ensure that a coherent, consistent disclosure and reporting regime is adopted. Any increase in disclosure requirements, particularly if the required information is difficult to obtain, will likely

[3] For example, the American Securitization Forum initiative, Project RESTART, aims to restore investor confidence in ABS by, among other things, improving disclosure and reporting and standardizing representations and warranties on certain types of ABS. See http://www.americansecuritization.com/story.aspx?id=2655. In addition, the Commercial Mortgage Securities Association is currently working on the Investor Reporting Package 6.0 to address investor and industry concerns with respect to continuing reporting regarding commercial mortgage-backed securities. See http://www.cmsaglobal.org/IndustryStandards.aspx?id=10078.

increase costs of ABS transactions, and revised ongoing reporting requirements will potentially require significant outlay by service providers to update systems to monitor and track new reporting requirements. Further, the development of increased disclosure requirements may delay the ability of ABS issuers to start securitizing again, as the time needed to prepare for these changes is likely to be significant.

It is unclear how disclosure regarding the compensation of brokers and originators would be implemented, particularly in light of the Proposal's recommendation to change how these parties are compensated. In certain types of transactions, such as RMBS, from a practical perspective it may be difficult to provide disclosure on compensation of brokers given the number of potential brokers involved with the loans in one transaction.

Increased Regulation of the Rating Process

The Proposal calls for a fairly dramatic overhaul of the credit ratings for structured products that could have severe consequences for the securitization industry. Specifically, the Proposal requires:

- Differentiating between the credit ratings for structured products and unstructured debt;
- Disclosure by rating agencies of:
    - Conflicts of interest.
    - Performance measures to enable comparisons across products and rating levels to provide meaningful measures of the uncertainty and potential volatility.
    - Which risks, precisely, the rating process is designed to assess. Specific examples noted are likelihood of default and/or loss severity in event of default and disclosure of the fact that structured products generally rely on diversification of risk through the asset pool and how that differs from risks of corporate debt.
    - Which material risks are not reflected by the rating.
    - The methodology used by the rating agencies to rate structured finance products, to enable investors and others to make their own determinations as to allow users of credit ratings and market observers to reach their own conclusions about the adequacy of the methodologies;

- Rating agencies to maintain robust policies and procedures to manage conflicts of interest and otherwise ensuring the integrity of the ratings process.

- Disclosure by the rating agencies to the SEC of any unpublished rating agency data and methodologies.

Creating a new category or other differentiation of credit ratings for structured products would result in a significant change for the industry as well as potentially severely limiting the pool of potential investors. Many investors are limited by policy, governing documents or regulation in the ratings on investments they are permitted or required to make. A wholesale change in the ratings for structured products would require changes in regulation and policies that would potentially be costly and time consuming. As a result, potential investors in ABS would be limited both initially and potentially for some time. It is not clear that all such regulations and policies would eventually be changed to match the new structured product ratings, possibly restricting the pool of investors permanently.

In addition, increased confusion regarding the meaning of ratings may result. While the Proposal is striving to improve investor understanding of the rating process and methodologies, requiring this type of differentiation will introduce a new element requiring explanation and disclosure and distract the focus from the other important issues, which are clarity and transparency in the rating process itself. A similar ratings differentiation requirement was previously proposed by the SEC and was almost universally opposed by the securitization industry, including investors.[4]

Securitization Reform and OTC Derivatives

The proposals specifically aimed at the securitization markets focus on recommendations to remedy weaknesses in loan underwriting standards, accounting, reporting and rating agency criteria. Though not specifically addressed in the discussion of proposals for the securitization markets, the proposed regulation of the over-the-counter ("**OTC**") derivatives market could have a substantial impact on whether the use of embedded derivatives in securitization transactions will be viable under the proposed regulatory reform. These proposals substantially echo many regulatory and legislative proposals that have been made over the last year with respect to OTC derivatives and credit default swaps ("**CDS**"), including the objectives set forth in Secretary Geithner's Regulatory Reform of OTC Derivatives Market announced on May 13, 2009.

[4] While the industry supports many of the suggested changes to the rating process and disclosures, George Miller, executive director of the ASF has stated that "we strongly oppose differentiated ratings for structured credit products". http://www.reuters.com/article/marketsNews/idUSN1734054320090617, June 17, 2009.

Increased Regulatory And Legal Requirements On Both "Standardized" And "Customized" OTC Derivatives

Specific elements of the proposed comprehensive regulation of the OTC derivatives market (including CDS) include:

- "Standardized" OTC derivatives:
    - Regulators would require clearing of all "standardized" OTC derivatives through regulated central counterparties ("CCPs").
    - CCPs would impose "robust margin requirements as well as other necessary risk controls."
    - There would be a presumption that if an OTC derivative is accepted for clearing by one or more CCPs it is required to be cleared as a "standardized" OTC derivative on a CCP and may not be treated as a "customized" OTC derivative.
- "Customized" OTC derivatives:
    - Derivatives dealers, banks and bank holding companies would be subject to a robust regulatory regime including increased capital requirements on OTC derivatives, business conduct standards, reporting requirements and conservative requirements on initial margins on counterparty credit exposures.
- Increased transparency of the OTC derivative markets:
    - SEC and CFTC would impose recordkeeping and reporting requirements (including aggregate data on open positions and trading volumes), which requirements may be satisfied to the extent transactions are cleared through a CCP or transactions are reported to a regulated trade repository.
    - Confidential reporting on any individual counterparty's trades and positions would be provided to the SEC, CFTC and the institution's primary regulator.

For a more detailed description of the proposed regulation of the OTC derivatives market, see our clients and friends memo "Obama Proposal for Regulatory Reform as It Relates to OTC Derivatives Markets"[5].

Potential Impact on Use of Embedded Derivatives in Securitization Transactions

Although "plain vanilla" interest rate caps and swaps and currency swaps comprise a great portion of the derivatives used in securitization transactions, there are several factors that could make their qualification as either "standardized" or "customized" OTC derivatives problematic:

- Although the terms of "plain vanilla" interest rate caps and swaps and currency swap confirmations may be fairly standard within the OTC derivatives market, in a securitization transaction such OTC derivatives are governed by highly-tailored swap documents reflecting rating agency criteria and SPV criteria.

- "Standardized" OTC derivatives would be required to be cleared by the parties through regulated CCPs, however it is the unlikely that an SPV issuer in a securitization transaction would have the financial capability to satisfy membership and initial margin requirements for a CCP.

- It would be an added cost to any securitization transaction if the SPV issuer was subject to initial margin requirements under a "customized" OTC derivative.

- Increased capital requirements on "customized" OTC derivatives would also impose an increased cost of entering into OTC derivatives with securitization transactions.

- As either "standardized" or "customized" OTC derivatives, the SPV issuer could incur increased recordkeeping and reporting requirements.

The proposal to have the SEC strengthen the regulation of credit agencies and require the rating agencies to maintain "robust policies and procedures" may lead to revised criteria for hedge counterparties in rated securitization transactions, including the possibility of increased collateral posting and reporting requirements.

[5] June 22, 2009, http://www.cadwalader.com/assets/client_friend/062209RegulatoryReform_OTCDerivatives.pdf.

Registration Under Advisers Act by Managers of CDOs and CLOs

The Proposal would require that all advisers to hedge funds and "other private pools of capital" register under the Advisers Act if their assets under management exceed an unspecified "modest threshold."

If enacted in the manner proposed, many CDO managers would be required to register with the SEC. However, the precise contours of the term "private pools of capital" remain unclear, as does the status of foreign advisers. Query, for example, whether advisers that manage funds that do not invest in securities (e.g., CLOs) would be required to register. The Proposal suggests that the applicable requirements may vary across the different types of private pools, and this type of tailoring would appear to be essential if "private pools of capital" is intended to have a broad sweep. The types of disclosures that would be made to creditors and counterparties also is unclear, as there is little or no precedent for government-mandated disclosure in a non-customer, non-investor context.

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