Securitization

Risk Retention Requirement

Under the Dodd-Frank Act, a securitizer[1] must retain no less than 5% of the credit risk in assets it sells into a securitization.[2] The retention threshold may be decreased below 5% if the quality of the underwriting standards employed by the originator[3] of the assets would indicate that those assets have less credit risk. Further, the risk retention requirement does not apply to "qualified residential mortgages"[4] if these are the only assets in the pool collateralizing the asset-backed securities[5] ("ABS"), but the issuer must certify that it has evaluated the effectiveness of its internal controls to ensure that all the assets backing the ABS are, in fact, qualified residential mortgages. ABS backed by tranches of other ABS are not eligible for the qualified mortgage exemption, even if the underlying ABS is backed exclusively by qualified residential mortgages.

The Act requires the SEC and the federal banking agencies[6] to promulgate regulations specifying the allowable forms and minimum duration of risk retention.[7] For commercial mortgages, the regulations must set forth the type of risk retention that would be acceptable, including:

- the retention of a specified amount or percentage of the total credit risk of the commercial mortgage;
- the retention of the first-loss position by a third-party purchaser that negotiates for this position, holds adequate financial resources to back losses, performs due diligence on all the commercial mortgages before the issuance of the securities and otherwise meets standards analogous to those required for a securitizer;

[1] "Securitizer" is defined in the Act as (i) an issuer of an asset-backed security or (ii) 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. Act § 941(b) (to be codified at Exchange Act § 15G(a)(3)).

[2] Act § 941(b) (to be codified at Exchange Act § 15G(c)(1)(B)).

[3] "Originator" is defined in the Act as a person who (i) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security and (ii) sells an asset directly or indirectly to a securitizer. Act § 941(b) (to be codified at Exchange Act § 15G(a)(3)).

[4] This term is to be defined jointly by the federal banking agencies, the SEC, the Secretary of Housing and Urban Development and the Director of the Federal Housing Finance Agency, taking into consideration factors that have historically resulted in a lower default risk. Such definition, however, cannot be less restrictive than the definition of "qualified mortgage" as defined under Section 129C(c)(2) of the Truth in Lending Act, as amended by Title XIV of the Act, which essentially means a mortgage (a) that is fully amortizing and does not have any unconventional attributes, such as interest-only payments, principal increases and balloon payments, (b) for which the basis of the borrower's qualification is verified and documented, (c) that complies with the debt-to-income ratio or other affordability regulations set by the Board of Governors and (d) for which the total points and fees payable do not exceed 3% of the loan amount.

[5] "Asset-backed security" is defined in the Act as a "fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset." The definition includes "(i) a collateralized mortgage obligation; (ii) a collateralized debt obligation; (iii) a collateralized bond obligation; (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the SEC, by rule, determines to be an asset-backed security for purposes of this section." The term does not include "a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company." Act § 940(a) (to be codified at 15 U.S.C. § 78c(A)(77)).

[6] The term "federal banking agencies" under the Act means the Office of the Comptroller of the Currency, the Board of Governors and the FDIC. Act § 941(b) (to be codified at Exchange Act § 15G(a)(1)).

[7] Act § 941(b) (to be codified at Exchange Act § 15G(c)(1)(C)).

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- the existence of adequate underwriting standards and controls (as determined by the federal banking agencies and the SEC); and
- provision of adequate representations and warranties and related enforcement mechanisms.

Separately, the federal banking agencies and the SEC must establish risk retention standards with respect to collateralized debt obligations, securities collateralized by collateralized debt obligations and similar instruments collateralized by other ABS.[8] The Act also requires regulations to establish underwriting standards for different asset classes, including residential mortgages, commercial mortgages, commercial loans and auto loans.

Under the Act, the federal banking agencies and the SEC must allocate the risk retention obligations between a securitizer and an originator by reducing the percentage of the retained risk required to be held by the securitizer by the percentage required to be held by the originator.[9] The following factors will also bear on the risk retention allocation:

- whether the assets transferred into a securitization reflect a lower credit risk;
- whether the form or volume of the securitization transaction creates incentives for imprudent origination; and
- the possible impact of risk allocation on consumer credit (which is not to include credit risk transfer to a third party).[10]

The Act prohibits hedging or transferring the retained credit risk, but provides for exemptions or adjustments to the retention requirement and the hedging prohibition.[11] These exemptions are to be jointly issued by the federal banking agencies and the SEC. The exemptions must ensure high underwriting standards and also promote sound risk management practices, improve credit access for businesses or consumers, or otherwise serve the public interest and protect investors. In addition, certain financial assets of institutions subject to the supervision of the Farm Credit Administration (including the Federal Agricultural Mortgage Corporation) and certain financial instruments insured or guaranteed by the United States or an agency of the United States (including the Federal Housing Administration) will not be subject to the risk retention requirements.

The regulations described above are required to be promulgated under the Act and will become effective one year after final rules are published for securities backed by residential mortgages and two years after final rules are published for securities backed by all other classes of assets.[12] It is unclear whether and how the proposed requirements will apply to outstanding ABS transactions. Additionally, the Chairman of the Council is required to conduct a study on the macroeconomic effects of the risk retention requirements with a particular focus on the cause and prevention of real estate price bubbles, and issue a report to Congress within 180 days after the Act is enacted.[13]

On April 7, 2010, the SEC issued a release under the Securities Act (the "ABS Release") in which it proposed amendments to the rules applicable to ABS issuers.[14] In the ABS Release, the SEC proposed

[8] Act § 941(b) (to be codified at Exchange Act § 15G(c)(1)(F)).

[9] Act § 941(b) (to be codified at Exchange Act § 15G(d)(1)).

[10] Act § 941(b) (to be codified at Exchange Act § 15G(d)(2)).

[11] See Act § 941(b) (to be codified at Exchange Act § 15G(e)).

[12] Act § 941(b) (to be codified at Exchange Act § 15G(i)).

[13] Act § 946(b).

[14] Securities Act Release No. 91177 (the "ABS Release"), published in the Federal Register on May 3, 2010.

risk retention requirements that are different from those contained in the Act. The SEC proposals apply to "sponsors" of securitizations, which are the same entities as securitizers but do not include "issuers of ABS." Sponsors must retain an interest in the issued ABS rather than in the underlying assets. They must retain a 5% "vertical slice" of each ABS transaction, consisting of 5% of each tranche of securities issued. The SEC did not provide for reductions in the required risk retention due to better underwriting standards, enforceable repurchase obligations or risk retention by originators. The SEC will need to revise its proposed risk retention rules to cover the underlying assets rather than the issued ABS and to take into account the variables identified in the Act which may be considered in reducing the risk retention burden for assets and asset classes that are of a better credit quality and/or for originators with superior underwriting standards and asset repurchase track records.

As a separate matter, the "Garrett amendment" to Title I of the Act, as originally approved by the House of Representatives, would have established an oversight program for the covered bond market as an alternative to the traditional ABS market.[15] Specifically, the Garrett amendment legislation included standards with respect to eligible assets, asset classes and over-collateralization and set procedures upon the occurrence of a default or insolvency with respect to the covered bond issuer. Although not part of the Act, the proposed framework for covered bonds will continue to be the subject of discussion for potential legislation in the future, as it has seemingly gained sufficient support among members of the Senate and of the House.

Disclosure, Due Diligence and Reporting Requirements

The Act requires each issuer of ABS, at a minimum, to disclose asset-level or loan-level data, if such data are necessary for investors to independently perform due diligence, including the identity of brokers or originators of the assets, compensation of such brokers or originators, and the amount of risk retained by the originator or securitizer.[16] A securitizer also must disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizer, so investors can identify asset originators with clear underwriting deficiencies. The Act also requires rating agencies to include in their rating reports for each ABS a description of the representations, warranties and enforcement mechanisms for the ABS being rated and how the ABS transaction differs from similar securities.[17]

In the ABS Release, the SEC also proposed extensive asset-level data requirements. The SEC proposed 28 unique data items or "points" that would be applicable for most ABS transactions, as well as additional data points for specific data classes — for example, an additional 137 data points for residential mortgage-backed securities. In addition, ABS issuers would be required to update these data points, as well as prepare additional data points relating to asset performance, in their ongoing periodic reports relating to each of the scheduled distribution dates for their ABS issuances. For credit card securitizations, the SEC identified 14,256 distinct categories of various asset characteristics relating to, *e.g.*, obligor credit scores, state of residence, and delinquency. For each of these "grouped account" categories, issuers must provide aggregate calculations of credit limit, account balance, number of accounts, and the weighted average annual percentage rate, with and without the deduction of servicing fees. The final asset-level disclosure requirements applicable to ABS will likely consist of an amalgam of the proposals in the ABS Release and those contained in the Act.

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[15] The Garrett amendment was ultimately excluded from the Act.

[16] Act § 942(b) (to be codified at 15 U.S.C. § 77g(c)(2)(B)).

[17] Act § 943.

While asset-level disclosure requirements are intended to enhance investors' due diligence review, the Act further requires the SEC to issue rules requiring issuers of ABS to conduct their own review of the underlying assets and to disclose the nature of such review.

Finally, the Act excludes ABS from the automatic reporting suspension provision of the Exchange Act that permits issuers to suspend their reporting obligations after one year if their securities are held by fewer than 300 holders.[18] Accordingly, publicly registered ABS issuers would be required to continue making periodic disclosures as long as their ABS remained outstanding, even if fewer than 300 security holders held such ABS. Nevertheless, the SEC may continue to provide for the suspension or termination of any ABS issuer's reporting requirements by rule or regulation, as it deems necessary and appropriate in the public interest or to protect investors. In the ABS Release, the SEC eliminated automatic reporting suspension for ABS issuers using the shelf registration process, but not for other public issuers.

Despite the potentially lengthy implementation period for the provisions of the Act, securitizers may wish to begin generating, assembling and disclosing the extensive asset level data required by the ABS Release and by the provisions of the Act as part of their efforts to implement "best practices" in their securitization business and to create the necessary facilities and processes that will allow them to comply with the new asset-level disclosure rules, once they have been implemented.

Credit Rating Agency Regulation; Removal of Statutory References to Credit Ratings

The Act also amends the Exchange Act by directing the SEC to conduct a two-year study on the credit rating process for structured finance products,[19] the related conflicts of interest issues and the feasibility of establishing a system in which a self-regulatory organization assigns Nationally Rated Statistical Ratings Organizations ("NRSROs") to determine the ratings of structured finance products.[20] Upon completion of the study and submission of its findings to the Senate and House committees, the SEC will have the authority to establish a mechanism for assigning NRSROs to determine the initial credit ratings of structured finance products in a manner that would prevent issuers from "shopping" among NRSROs. In doing so, the SEC must give thorough consideration to the so-called "Franken amendments," under which an issuer desiring an initial credit rating for a structured finance product must submit a request to the Credit Rating Agency Board (a self-regulatory organization to be established), which will select an NRSRO from a pool of qualified NRSROs based on a selection method intended to reduce the conflicts of interest inherent to the issuer-paid structure.[21] Separately, the Act requires the SEC to establish the Office of Credit Ratings to administer SEC rules governing NRSRO rating practices, promotion of ratings accuracy and conflict of interest matters.[22] Each NRSRO will be subject to an annual examination by the Office of Credit Ratings.

To enhance transparency for users of credit ratings, the SEC will require NRSROs to provide extensive disclosure with respect to its ratings, including the main assumptions and principles used in constructing

[18] Exchange Act § 15(d).

[19] As used here, "structured finance product" means an asset-backed security as defined under the Act and any structured product based on an asset-backed security, as determined by the Commission, by rule.

[20] See "Credit Rating Agencies."

[21] Act § 939D. The Act further provides that the rating assignment system set forth in the "Franken Amendments" must be implemented unless the SEC determines that an alternative system would better serve the public interest and the protection of investors. Act § 939F(d).

[22] Act § 932(a) (to be codified at 15 U.S.C. § 78o-7(p)).

procedures and methodologies for the ratings, information on the uncertainty of the ratings, whether and to what extent third-party due diligence services have been used by the NRSRO, and an overall assessment of the quality of information available and considered in producing the particular ratings, in relation to the quality of information available to the NRSRO in similar issuances.[23] In addition, an NRSRO will be required to consider information about an issuer that it obtains from a source other than the issuer or underwriter and that it finds credible and potentially significant to a rating decision. Another important amendment with respect to information disclosure is the elimination of the exemption for rating agencies under Regulation FD, which must occur within 90 days of enactment. It is unclear if the intent of this amendment is to cause issuers to disclose any material nonpublic information provided to rating agencies for purposes of their rating decisions without any exception, or if the issuer still can withhold such information to the extent the rating agencies "expressly agree to maintain the disclosed information in confidence" for purposes of the exemption provided under Rule 100(b)(2)(ii) of Regulation FD. See "Credit Rating Agencies."

In terms of rating agency liabilities, the Act enables investors to bring private actions against a credit rating agency if there is a "strong inference" that the agency "knowingly or recklessly" failed to conduct a reasonable investigation of the factual elements related to the rated security that the credit rating agency relied on when evaluating credit risks or failed to obtain verification of such elements from a competent independent source. In the context of rated ABS transactions, this could mean that ABS issuers and other transaction parties will need to consider the engagement of third parties that are independent from the ABS issuers or underwriters to conduct a review of the assets underlying the ABS for purposes of the rating agency's verification of the facts underlying the ratings. In addition, the Act eliminates the exemption afforded under Rule 436(g) of the Securities Act to NRSROs with respect to expert liability for purposes of Section 11 of the Securities Act. It is unclear, however, how the elimination of the expert exemption will impact rating agencies, particularly with respect to Item 1120 of Regulation AB under the Securities Act, which requires the disclosure of the identity of each rating agency and the required minimum ratings in prospectuses to the extent an ABS issuance is conditioned upon the assignment of a rating.

To reduce dependency on credit ratings, the Act also amends certain statutes, including the Federal Deposit Insurance Act, the Exchange Act, and the 1940 Act, to remove references to specific ratings requirements and to insert instead standards of credit worthiness to be established by the FDIC, the SEC or the other applicable authority under the relevant statute. The SEC's stated goal in the ABS Release was to minimize investor reliance on credit ratings, so the foregoing requirements of the Act will create an additional set of rules with which ABS issuers will need to acquaint themselves.

Other changes relating to the regulation of credit rating agencies include the prohibition of NRSRO compliance officers from participating in the ratings, methodologies or sales functions; the SEC's authority to deregister an NRSRO for repeatedly issuing inaccurate ratings; testing and other qualification requirements for NRSRO analysts; and a requirement that at least half of the board of directors of an NRSRO (but not fewer than two of the board members) be independent directors.[24]

[23] Act § 932(a) (to be codified at 15 U.S.C. § 78o-7(s)(3)(A)).

[24] See Act § 932(a) (to be codified at 15 U.S.C. § 78o-7).