

F I N A N C I A L R E G U L A T O R Y R E F O R M

Improvements to the Asset-Backed Securitization Process

Subtitle D of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") pursues the general goal of investor protection in the specific context of asset-backed securitization (including commercial and residential mortgage securitizations). The Act emphasizes the importance of collateral quality in achieving this goal and focuses on two main objectives: implementing structural changes in the issuance of asset-backed securities ("ABS") to require risk retention by securitizers and originators and thereby promote the credit quality of the assets being securitized; and requiring additional disclosure relating to the securitized assets to enable investors to independently assess credit quality.

Risk Retention

ABS Issuers and Sponsors Required to Retain Interest in Transferred Assets

The keystone of the Act's approach is an effort to encourage less risky origination practices by requiring any securitizer (defined as an issuer of ABS or a sponsor of an ABS transaction) to retain an interest in a portion of the credit risk in any assets transferred, sold or conveyed by it through the issuance of ABS. Since securitizers would share in any losses suffered by investors due to poor performance of the collateral underlying the ABS, this "skin in the game" requirement is meant to encourage securitizers and originators to improve underwriting and risk management practices.

The Act charges the Securities and Exchange Commission ("SEC") and "Federal banking agencies" (defined as the Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve and Office of the Comptroller Currency) with jointly promulgating regulations to establish the nature, duration

and other details of this risk retention, and affords such agencies broad flexibility in doing so. The Act does, however, set forth general guidelines for such regulations. For instance, the Act establishes a default risk retention level of 5%, but gives the regulators discretion to require levels of greater than 5% and, within certain limitations, also allows for levels of less than 5%. The Act also requires that the regulations prohibit a securitizer from directly or indirectly hedging away or otherwise transferring the retained credit risk.

Establishment of Asset Classes and Tailored Risk Retention Requirements

The Act mandates that the SEC and Federal banking agencies jointly establish separate rules and risk retention standards for securities in each distinct asset class (e.g., commercial mortgages, residential mortgages, and automobile loans). The regulations defining these classes will include underwriting standards specifying the terms, conditions and characteristics that are consistent with low

credit risk for each class. Assets originated in compliance with the applicable class-specific standards may be eligible for risk retention levels of less than 5%.

Commercial Mortgage Assets

With respect to commercial mortgage assets, the Act requires that the implementing regulations specify the permissible types, forms and amounts of risk retention, and provides the regulators with some broadly defined options for doing so. The Act specifies that risk retention in the context of commercial mortgages may involve either a specified amount or a percentage of the asset's total credit risk. The Act also permits retention of a first loss position by a third-party purchaser that specifically negotiates the acquisition of such position, holds adequate loss reserves, performs due diligence on all individual assets in the pool and meets the same standards for risk retention that would be required of the securitizer. The Act provides that risk retention requirements for commercial mortgages may also include a determination with respect to the adequacy of underwriting standards and controls, and requirements relating to the adequacy of representations, warranties and enforcement rights.

Allocation or Risk Retention Between Securitizer and Originator

Significantly, the regulations must provide for the allocation of retained risks between the securitizer and originator (which may be an entity affiliated or unaffiliated with the issuer) where a securitizer purchases assets from an originator. The Act specifies that any such allocation of risk to an originator must reduce the percentage of risk retained by the securitizer by the percentage of risk retention allocated to such originator. The regulations providing for such allocations must consider: whether the terms, conditions and characteristics of the assets sold to the securitizer are consistent with low credit risk; whether the securitization market for a given class of loan or asset type has characteristics that encourage risky origination practices; and the potential impact of such allocation on the availability of credit on reasonable terms to consumers and businesses.

Exceptions and Exemptions

The Act includes a number of exceptions and exemptions for specific classes of assets or institutions (e.g., qualified residential mortgages; residential, multi-family or health care facility mortgage loans insured or guaranteed by the U.S. or an agency thereof; assets issued or guaranteed by the U.S.; and loans or other

financial assets made, insured, guaranteed or purchased by any institution chartered and subject to the provisions of the Farm Credit Act). The Act also authorizes more general exemptions as may be considered appropriate in the public interest and for the protection of investors. Any such exemptions, general or specific, must help ensure high quality origination standards, encourage appropriate risk management practices and improve business and consumer access to credit on reasonable terms.

Qualified Residential Mortgages

One of the most significant of these exemptions is applicable to qualified residential mortgages. The SEC, the Federal banking agencies, the Secretary of Housing and Urban Development and the Federal Housing Finance Agency are required to jointly issue risk retention regulations for securitized residential mortgage assets ("Residential ABS Rules"). Subject to some limitations, qualified residential mortgages will be exempt from the general 5% risk retention requirement as established by the Residential ABS Rules. The theory behind the exemption is that mortgages meeting the definition of "qualified residential mortgage" will represent assets of a sufficiently high credit quality to obviate the need for risk retention.

To ensure that this is the case, the rulemaking entities will jointly define the term "qualified residential mortgage" to reflect underwriting and product features historically associated with reduced risk of default, including: (i) documentation and verification of mortgagor financial resources; (ii) standards with respect to mortgagor income relative to housing and other monthly payment obligations; (iii) mitigation of the potential for payment shock on adjustable rate mortgages; (iv) mortgage guarantee insurance or other types of insurance or credit enhancement to the extent it reduces the risk of default; and (v) limitations on balloon payments, negative amortization, prepayment penalties, interest-only payments and other features associated with increased risk of default. However, the definition of "qualified residential mortgage" will not be permitted to be broader than the definition of "qualified mortgage" provided in the Truth in Lending Act, as amended by the Consumer Financial Protection Act of 2010 and regulations thereunder.

To qualify for the exemption, an issuer of ABS collateralized solely by qualified residential mortgages will be required to certify that it has effective internal controls for ensuring that all the assets collateralizing such issuance of ABS are qualified residential mortgages. ABS collateralized by tranches of other ABS

(whether or not this collateral includes residential mortgage backed securities backed by qualified residential mortgages) will not be eligible for this exemption.

Implications of the Act's Risk Retention Requirements

At this juncture, most of the details of the risk retention regime remain open; final regulations setting these details are not required until 270 days following the enactment of the Act (April 17, 2011). Following the publication of the final rules in the Federal Register, it will be up to an additional year for residential mortgages and two years for all other asset classes before these regulations become effective. As the rulemaking progresses, there are a few issues to watch: First, how is the risk retention sized and structured? It hardly bears mention that the higher the level of risk retention, the higher the real cost of funds from issuing ABS. The SEC's proposed revisions to Reg AB¹ that relate to risk retention are currently considering a minimum 5% level for securities publicly issued from a shelf registration statement.² Comments to the SEC proposals were due earlier in August; it remains to be seen how the SEC will react to industry requests for flexibility in this area. The SEC proposals contemplate retention of a "vertical slice" reflecting a 5% interest in each class of ABS in an offering, rather than a first loss position. It is not clear whether the final regulations will require a vertical slice, a first loss position or provide flexibility in satisfying the risk retention requirement. The characterization of a transfer as a true sale or for achieving off balance sheet accounting treatment will generally now require a more reasoned analysis. Any true sale or accounting analysis, however, would consider risk retention, in whatever form, as one feature among many in a transaction's structure.

Second, what are the rules and exceptions relating to the prohibition against securitizers' hedging their retained risk? The Act states that the regulations to be prescribed shall prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset. Again, current SEC proposals for the revised Reg AB may be instructive on how this prohibition may

¹ Asset Backed Securities, Securities Act Release No. 33-9117, 75 Fed. Reg. 23328 (proposed May 3, 2010).

² For a more detailed analysis of the SEC's proposed amendments to Reg AB, see our article entitled "SEC Proposes Extensive Reform to the Rules and Regulations for Public and Private Offerings of Asset-Backed Securities," *DechertOnPoint*, Issue 32 (April 2010).

be interpreted by the SEC and the Federal banking agencies as they prepare the final regulations. The SEC's Reg AB proposal provides that the 5% risk retention percentage is net of hedge provisions directly related to the securities or exposures taken by the sponsor or its affiliate. Additionally, these proposals would permit general hedges of market interest or currency exchange rate risks. The SEC's Reg AB proposal also provides that hedges tied to securities similar to those offered by the sponsor would not be taken into account in the calculation of the sponsor's risk retention. For example, under the proposed Reg AB rules, a sponsor could hold a security tied to the return of a broad index (e.g., the subprime ABX.HE index) without that being considered a hedge on the particular security offered by the sponsor unless that security itself was in the index.

Third, how are specific asset classes defined and what are the underwriting standards for originators in those classes? Participants in a particular securitization market will want to track developments to see if the proposed standards deviate significantly from current practices and assess the costs and benefits of adjusting origination standards against facing potentially higher risk retention requirements. Additionally, since the Act allows for the creation of exemptions for specific asset classes on other bases, participants should focus on whether any contemplated exemptions affect the asset classes which with they are involved.

Disclosure and Reporting Obligations: To Be Implemented by SEC Rule-Making

Not only does the Act seek to create incentives for more prudent origination practices, but it also seeks to improve disclosure to enable investors to better assess the credit quality of the assets underlying any given issuance of ABS. The Act pursues this goal by requiring the SEC to adopt regulations in a number of areas relating to disclosure and reporting obligations.

Asset-Level Disclosure Requirements

One category of regulations mandated by the Act would create a set of specified data points required to be disclosed by each issuer of ABS with respect to the assets backing that ABS. As is the case with risk retention, the Act leaves a good deal of discretion with the regulators but does set forth certain minimum requirements for the regulations. The Act requires the SEC to establish the format of the disclosure provided by ABS issuers in a manner that facilitates a compari-

son of data across ABS issuances of similar asset classes. The Act also specifies that the regulations must require disclosure of asset or loan-level data if necessary for investors to perform independent diligence. This data would include unique identifiers of loan brokers or originators, the type and amount of compensation paid to such parties and the amount of risk retained by the originator and the securitizer.

Requirements Related to Registration and Reporting

Under the Act, the SEC must adopt rules relating to registration statements required to be filed by ABS issuers. These rules would require such an issuer to perform diligence on the assets underlying the ABS and to disclose the nature of such diligence.

The Act eliminates the eligibility of ABS issuers for the automatic suspension of the Securities Exchange Act of 1934 obligation to file periodic reports that is otherwise applicable to securities held by fewer than 300 persons. The Act also grants the SEC the authority to adopt new rules for the suspension or termination of such duty to file that would be applicable to ABS issuers, which rules may be different for various asset classes and issuer categories of ABS.

Disclosures Required from NRSROs

Lastly, the Act requires the SEC to promulgate regulations to require each nationally recognized statistical rating organization (“NRSRO”) rating an issuance of ABS to include in its rating report a description of the representations and warranties relating to the ABS, as well as the enforcement rights available to investors and a description of how these compare with the representations and warranties and enforcement rights in similar ABS issuances. Such regulation will also require any securitization sponsor to disclose its history of repurchase requests and the fulfillment thereof across all individual ABS issuers aggregated in the securitization platform of such sponsor. The purpose of this regulation is to allow investors to identify sponsors and originators with deficient underwriting or risk management practices, thereby contributing to the informational foundation on which investment decisions are made.

Implications of the Act’s Disclosure Requirements

As is the case with the risk retention requirements, most of the details of the enhanced disclosure requirements

remain open. The SEC alone is charged with issuing the disclosure regulations. While the Act does not impose a timeline with respect to regulations relating to asset-level disclosure, it does require final regulations relating to issuer diligence and NRSRO disclosures no later than 180 days following the enactment of the Act (January 17, 2011).

The Act contemplates different types of asset-level disclosure for different asset classes. Market participants will want to pay attention as the proposed disclosure requirements for different classes are developed and assess whether the proposed data points for an asset class are material to investors in that type of ABS, are practical to assemble and report, and are necessary in light of existing market practices.

Conclusion

While the devil will certainly be in the details to be established by regulation, the Act does provide a clear enough indication of its general thrust to draw some broad conclusions in advance of the final rules. Securitizers and originators must be prepared to retain some sort of interest in the credit risk of the assets they channel into securitization transactions. Likewise, issuers and NRSROs must be prepared to provide disclosure relating to the individual assets being securitized and the performance history of the sponsor’s platform. These complementary requirements have been designed to move the interests of originators, issuers and investors into closer alignment, to have a favorable impact on the credit quality of securitized assets, and to give investors better tools to make an assessment of this credit quality. Compliance with these requirements will certainly impose burdens on the ABS market and may have negative impacts on market participation and credit availability (both for issuers and consumers). Ultimately, the Act’s success at meeting its stated goals, and the costs it imposes in doing so, will be determined by the specific requirements and exemptions established in its implementing regulations.

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