Current as of June 17, 2010

Credit Risk Retention ("Skin-in-the-Game") Legislative and Regulatory Developments

During the summer of 2009, the Treasury Department released an outline of provisions the Obama Administration supported for financial reform legislation, including credit risk retention. Since that time, several proposals emerged which require certain creditors to retain a specified percentage of the credit risk associated with a transferred loan, and securitizers to retain a specified percentage of the credit risk associated with a pool of securitized financial assets, in each case without being able to hedge or otherwise transfer the retained credit risk. Below is a summary discussion of the House Bill and the Senate Bill (and the SEC proposed rule is discussed in an earlier presentation).

- **The House Bill** — On December 11, 2009, the House of Representatives passed the Wall Street Reform and Consumer Protection Act of 2009, H.R. 4163 (the "**House Bill**"). The Credit Risk Retention Act of 2009 is included in that bill as Title I, Subtitle F.
- **The Senate Bill** — On May 20, 2010, the Senate passed The Restoring American Financial Stability Act of 2010 (the "**Senate Bill**"). Title IX, Subtitle D contains "Improvements to the Asset-Backed Securitization Process."
- **The SEC Proposed Rule** — In its April 7, 2010 Release 33-9117, the SEC proposed significant revisions to Regulation AB and other rules (the "**SEC Proposal**") regarding the offering process, disclosure and reporting for asset-backed securities, including credit risk retention requirements for shelf offerings of asset-backed issuers (discussed in separate presentation).

The House Bill and the Senate Bill must now be merged in negotiations by a House-Senate conference committee, which will reconcile the differences between the two bills. The reconciliation process began on June 10 and is anticipated to last several weeks. House and Senate Democrats are working towards sending a consolidated bill to President Obama to sign into law by June 4, 2010.

The House Bill

Retention of an Economic Interest

Unless amended, the House Bill would require the appropriate agencies (defined below) to prescribe regulations:

- 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 including for the purpose of including such loan in a pool of loans backing an issuance of asset backed securities"; and
- 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."

Definitions

"Appropriate agencies" are, with respect to (i) any mortgage insured under Title II of the National Housing Act, the Secretary of Housing and Urban Development, (ii) 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, (iii) any loan insured by the Rural Housing Service, the Rural Housing Service or (iv) any loan or asset-backed securities not covered by clauses (i), (ii) or (iii), jointly, the Federal Reserve Board, the FDIC, the Office of Thrift Supervision, the Officer of the Comptroller of Currency, the National Credit Union Administration Board and the SEC.

"Asset-backed security" definition is consistent with the Reg AB definition.

"Creditor" is undefined.

"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."

"Securitization vehicle" is defined as "a trust, corporation, partnership, limited liability entity, special purpose entity, or other structure that: (i) is the issuer, or is created by the issuer, of pass-through certificates, participation certificates, asset-backed securities, or other similar securities backed by a pool of assets that includes loans; and (ii) holds such loans."

5% Credit Risk Retention

Regulations would prohibit creditors and securitizers from directly or indirectly hedging or otherwise transferring credit risk that a creditor or securitizer is required to retain. The regulations would require creditors and securitizers to retain at least 5% 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. The appropriate agencies would be able to decrease the 5% credit risk requirement, or exempt a creditor or securitizer from that requirement if:

- the credit underwriting by the creditor or due diligence by the securitizer meets standards prescribed by the appropriate agency; and
- the loan meets terms, conditions, and characteristics that are determined by an appropriate agency to reflect loans with reduced credit risk, such as (i) loans that meet certain interest rate thresholds, (ii) loans that are fully amortizing, and (iii) loans that are included in a securitization in which a third-party purchaser specifically negotiates for the purchase of the first-loss position and, provides due diligence on all individual loans in the pool prior to the issuance of the asset-backed securities and retains a first loss position.

The appropriate agencies would be able to increase the 5% credit risk retention percentage if the underwriting or due diligence is insufficient. Regulations would also require the credit risk retained to be no less at risk of loss than the average of the credit risk not retained.

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

- insured, guaranteed or administered by the Secretary of Education, the Secretary of Agriculture, the Secretary of Veterans Affairs, or the Small Business Administration; or
- made, insured, guaranteed, or purchased by any person subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation.

Additional Powers of Appropriate Agencies

In addition, the appropriate agencies may:

- 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; or

- 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 to 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."

The Senate Bill

Retention of Economic Interest

The Senate Bill requires, within 270 days, "the Federal banking agencies and the [SEC] to jointly prescribe regulations to require any securitizer to retain an economic interest in a 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."

Definitions

"Asset-backed security" is defined directly in the Senate Bill as "(A) 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 that asset, including: (i) a collateralized mortgage obligation; (ii) a collateralized debt obligation, (iii) a collateralized bond obligation; (iv) a collateralized obligation of asset-back 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 and (B) 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."

"Federal banking agencies" means the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation."

"Originator" means a person who: (A) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and (B) sells an asset to a securitizer.

"Securitizer" is defined as "(A) an issuer of 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."

5% Credit Risk Retention

Regulations would prohibit a securitizer from directly or indirectly hedging or otherwise transferring credit risk that the securitizer is required to retain with respect to an asset. Regulations would require securitizers to retain at least 5% of any asset that is transferred, sold or conveyed to a third party through the issuance of an asset-backed security by the securitizer, or less than 5% if the originator of the asset meets certain underwriting standards. The Senate Bill also provides that regulations establish asset classes with separate rules for securitizers of different classes of assets (e.g. commercial mortgages, auto loans).

<u>Carve-outs from the 5% Risk Retention</u>: The as-approved Senate Bill contains a recent amendment which, among other things, exempts "qualified residential mortgages"[1] from the 5% risk retention

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[1] 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 account various underwriting and product

requirement. Further, the Senate Bill establishes minimum underwriting standards for residential mortgage loans, including a prohibition against extending residential mortgage loans unless, "based on verified and documented information", the borrower has "a reasonable ability to pay the loan, according to its terms, and all applicable taxes, insurance and assessments."

Specifically with regard to commercial mortgages, the Senate Bill allows regulators to flexibly structure skin-in-the-game legislation in several approved ways, including allowing a "third-party purchaser that specifically negotiates for the purchase of such first loss position" to satisfy the risk-retention requirement.

Regulations would specify the permissible forms of risk retention that would be required and the minimum time period that securitizers would be required to retain such risk. The Federal banking agencies and the SEC would be able to grant total or partial exemptions from the risk retention requirement for any securitizations as may be appropriate in the public interest or for the protection of investors.

The risk retention requirement under the Senate Bill will not apply to a Farm Credit System institution, including the Federal Agricultural Mortgage Corporation, that is chartered and subject of the provisions of the Farm Credit Act of 1971, as amended.

Allocation of Risk Retention

Regulations would also provide for the allocation of risk retention obligations between securitizers and originators where a securitizer purchases assets from an originator, with the required percentage of credit risk retained by a securitizer reduced by the percentage required to be retained by the originator. The Federal banking agencies and the SEC would be required to consider:

- "whether certain assets sold to the securitizer have characteristics that reflect reduced credit risk;
- whether the form or volume of transactions in securitization markets creates incentives for imprudent origination of the type of loan or asset to be sold to the securitizers; and
- the potential impact of risk retention obligations on the access of consumers and businesses to credit on reasonable terms, which may not include the transfer of credit risk to a third party."

Additional Powers of Federal Banking Agencies and the SEC

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:

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

Comparing the Bills

While earlier drafts of the Senate Bill proposed a 10% risk retention requirement, the approved Senate Bill matches the House Bill's 5% credit risk retention requirement. The House Bill fails to clarify whether both the creditor and the securitizer would be required to comply with individual 5% credit risk retention requirements or whether the 5% retention could be allocated among parties. In the Senate Bill, the definition of "securitizer" includes both issuers and sponsors of asset-backed securities. The Senate

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features, including but not limited to, documentation and verification of income, income to debt service ratios, prohibiting the use of balloon payments or negative amortization, etc.

Bill fails to clarify whether both the issuer and the sponsor would have to retain the 5% credit risk percentage, or whether the retention requirement would be satisfied by either entity retaining the risk. However, the Senate bill does specifically mandate a reduction of the 5% requirement to the securitizer by a retention amount to be determined to be retained by an originator.

The definition of “securitizer” is broader in the Senate Bill than in the House Bill. However, the Senate Bill’s requirement for credit risk retention appears to be less burdensome than the House Bill’s because the Senate Bill applies only to securitizers as opposed to all creditors.

The House Bill defines “asset-backed securities” by reference to Regulation AB, while the Senate Bill provides its own, more expanded definition. However, the Senate Bill explicitly removes internal financing between parent and subsidiary from the definition of asset-backed securities.

Neither bill specifies the form of risk retention (for example, retention of participation interests in the transferred loans or guarantees in a portion of the losses on them) or whether the credit risk must be retained on a pool-wide or individual loan basis. Both bills grant the Federal banking agencies and the SEC significant flexibility in adopting exemptions, exceptions or adjustments to the credit risk retention requirement. Until regulations are actually issued, it is difficult to approximate the impact on securitization markets and lending.

Additional Provisions

Both the House Bill and Senate Bill contain additional provisions related to securitization. For example, currently Section 4(5) of the Securities Act permits 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. Both bills would eliminate this Securities Act registration exemption, but this elimination should not adversely affect the private whole loan mortgage market, as there is little evidence that purchasers and sellers of mortgage loans have significantly relied upon this exemption in the past.

The House Bill also includes requirements for certain federal agencies to issue reports back to Congress on (i) the combined impact of (1) the credit risk retention requirements and (2) FAS 166 and 167 on each individual class of asset-backed securities, including statutory and regulatory recommendations for eliminating any negative impacts on the continued viability of the asset-backed securities securitization markets and on the availability of credit for new lending, and (ii) the macroeconomic effects of the risk retention requirements, emphasizing the potential beneficial effects of stabilizing the real estate market. The Senate Bill does not include requirements for these reports.

The Senate Bill also includes a requirement that the SEC issue rules relating to registration statements filed by issuers of asset-backed securities, requiring any such issuer to perform a due diligence analysis of the assets underlying such asset-backed securities and to disclose the nature of such due diligence analysis. The House Bill does not include such a requirement.

The House Bill and the Senate Bill both contemplate continued periodic reporting by issuers under the Securities Exchange Act even after registered holders fall below 300 for such time as specified by the SEC.

Both Bills require the SEC to (i) “set standards for the format of the data provided by issuers of an asset-backed security, which, to the extent feasible, facilitates comparison of such data across securities in similar type of asset classes” and (ii) require issuers of asset-backed securities at a minimum to disclose asset-level or loan-level data necessary for investors to independently perform due diligence, including disclosure of information with respect to brokers and originators regarding the nature and extent of compensation and risk retention.

Both Bills require the SEC to prescribe regulations regarding representations and warranties mandating (i) certain securitization participants to disclose fulfilled and unfulfilled repurchase requests on an aggregate basis, and (ii) rating agencies to include in reports accompanying credit ratings a description of the representations, warranties and enforcement mechanisms available to investors and how such representations, warranties and enforcement mechanisms differ from those in similar issuances.

The Senate Bill contemplates joint rulemaking regarding the risk retention requirement by the SEC, the FDIC and the Office of Comptroller Currency. The House Bill contemplates joint rulemaking by the SEC, the National Credit Union Administration Board, the Fed, the Office of the Comptroller of the Currency, the Office of Thrift Supervisors and the FDIC.

Provision/Definition	House Bill	Senate Bill
"asset-backed security"	Consistent with the Reg AB definition.	"(A) 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 that asset, including: (i) a collateralized mortgage obligation; (ii) a collateralized debt obligation, (iii) a collateralized bond obligation; (iv) a collateralized obligation of asset-back 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 and (B) 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."
"securitizer"	"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."	"(A) an issuer 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."
5% credit risk retention	Applies to creditors (undefined) and securitizers.	Applies to securitizers. May be offset by some percentage of risk retained by originator and/or carve-outs from retention requirement.
Less than 5%	If (i) the credit underwriting by the creditor or due diligence by the securitizer meets standards prescribed by the appropriate agency; and (ii) the loan meets terms, conditions, and characteristics that are determined by an appropriate agency to reflect loans with reduced credit risk	If the originator meets certain underwriting standards (as promulgated by regulation)
Hedging or transferring retained risk	Creditors and securitizers prohibited from directly or indirectly hedging or otherwise transferring credit risk that a creditor or securitizer is required to retain	Same as House Bill, but excludes creditors
Regulations different by asset class	Silent	Provides that regulations establish asset classes with separate rules for securitizers of different classes of assets (e.g. commercial mortgages, auto loans)

Provision/Definition	House Bill	Senate Bill
Type of risk retention	To be determined by regulation	Same
Exceptions, exemptions, and adjustments to the 5% credit risk retention requirement and the hedging prohibition	Agencies may provide exemptions or adjustments if such action would (i) help ensure high quality underwriting standards for creditors and (ii) "facilitate appropriate risk management practices by such creditors, improve access of consumers to credit on reasonable terms, or otherwise serve the public interest."	Same as House Bill, but applies to securitizers and originators instead of creditors
Risk retention requirement does not apply to:	Any loan: (i) insured, guaranteed or administered by the Secretary of Education, the Secretary of Agriculture, the Secretary of Veterans Affairs, or the Small Business Administration; or (ii) made, insured, guaranteed, or purchased by any person subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation	A Farm Credit System institution, including the Federal Agricultural Mortgage Corporation, that is chartered and subject of the provisions of the Farm Credit Act of 1971, as amended
Elimination of Securities Act § 4(5)	Yes	Same
Due Diligence Disclosure (registration statement rules)	None	SEC to issue rules relating to registration statements filed by issuers of asset-backed securities, requiring any such issuer to perform a due diligence analysis of the assets underlying such asset-backed securities and to disclose the nature of such due diligence analysis.
Periodic Reporting	Continued periodic reporting by issuers under the Securities Exchange Act even after registered holders fall below 300 for such time as specified by the SEC	Same
Disclosure of asset-level or loan-level data	SEC to (i) "set standards for the format of the data provided by issuers of an asset-backed security, which, to the extent feasible, facilitates comparison of such data across securities in similar type of asset classes" and (ii) require issuers of asset-backed securities at a minimum to disclose asset-level or loan-level data necessary for investors to independently perform due diligence, including disclosure of information with respect to brokers and originators regarding the nature and extent of compensation and risk retention	Same

Provision/Definition	House Bill	Senate Bill
Representations and Warranties	SEC to prescribe regulations regarding representations and warranties requiring (i) certain securitization participants to disclose fulfilled and unfulfilled repurchase requests on an aggregate basis, and (ii) rating agencies to include in reports accompanying credit ratings a description of the representations, warranties and enforcement mechanisms available to investors and how such representations, warranties and enforcement mechanisms differ from those in similar issuances	Same
Report to Congress on effect of legislation	Fed to issue a report to Congress within 90 days of enactment on the combined impact of (1) the credit risk retention requirements and (2) FAS 166 and 167 on each individual class of asset-backed securities, including statutory and regulatory recommendations for eliminating any negative impacts on the continued viability of the asset-backed securities securitization markets and on the availability of credit for new lending Chairman of the Financial Services Oversight Council to issue a report to Congress within 180 days of enactment on the macroeconomic effects of the risk retention requirements, emphasizing the potential beneficial effects of stabilizing the real estate market	None
Joint Rulemaking	Joint rulemaking regarding the risk retention requirement by the SEC, the National Credit Union Administration Board, the Fed, the Office of the Comptroller of the Currency, the Office of Thrift Supervisors and the FDIC	Joint rulemaking regarding the risk retention requirement by the SEC, the FDIC and the Office of Comptroller Currency