Risk Retention is Coming — What Will it Look Like?

Following the meltdown of the financial markets in the United States in 2008, several ideas for changing the securitization process have emerged as potential "fixes" to prevent a repeat occurrence. One of these is risk retention or "skin in the game," which posits that if originators of assets to be securitized are required to retain a portion of the assets (or the resulting securities) or their related risk of loss, the originator's interests would be better aligned with those of investors, resulting in improved underwriting standards and credit quality. Another possible solution is increased disclosure or "transparency" by market securitizers and underwriters, which would enable investors to better assess the risks of asset-backed securities ("ABS") being offered for purchase. A third prong of the reform effort relates to the rating agency process and attempts to make the process more open and to mitigate conflicts of interest arising from the hiring and payment of the rating agencies by the issuer or securitization sponsor seeking a rating. All of these ideas (and more) are embodied in the nearly 850-page "Dodd-Frank Wall Street Reform and Consumer Protection Act" (the "Act"), which was signed by President Obama on July 21, 2010.

Differing versions of these three curative proposals are also included in two regulatory proposals circulated earlier this year. On May 3, 2010, the SEC published in the *Federal Register* a Proposed Rule containing significant revisions to Regulation AB and other rules under the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended (the "Exchange Act"), relating to the offering process, disclosure and reporting for asset-backed securities (the "Proposed SEC Rule"). On May 17, 2010, the FDIC published in the *Federal Register* its Notice of Proposed Rulemaking, Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection With a Securitization or Participation After September 30, 2010 (the "Proposed FDIC Rule" and, together with the Proposed SEC Rule, the "Proposed Rules"). This Client Alert focuses solely on the risk retention provisions included in the Act, the Proposed SEC Rule and the Proposed FDIC Rule. These provisions are inconsistent with each other in fundamental ways, and we hope that, prior to adoption of final rules, the SEC and FDIC will better align their rules with each other and with the Act, or that the SEC and FDIC will defer their existing proposed rulemaking concerning risk retention to the regulations to be issued under the Act. In any case, since the SEC and the FDIC are both among the federal agencies charged with issuing regulations under the Act, the Proposed SEC Rule and the Proposed FDIC Rule may offer some guidance as to the regulations that will ultimately emerge under the Act. Set forth below are summaries of the three sets of risk retention provisions,[1] followed by a comparison of the Act and the Proposed Rules and some comments on specific provisions that may prove problematic.

The Act

Section 941 of the Act amends the Exchange Act by adding a new Section 15G ("New Section 15G"), which provides that, not later than 270 days following the enactment of the Act, the Comptroller of the

[1] Please note that these summaries are intended to provide an overview, and accordingly a number of the details contained in the Act and the proposed regulations are omitted.

Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation (collectively referred to in New Section 15G as the "Federal banking agencies"), together with the Securities and Exchange Commission (the "SEC") and, solely in the case of residential mortgage assets, the Secretary of Housing and Urban Development ("HUD") and the Federal Housing Finance Agency (the "FHFA"), are to jointly prescribe regulations regarding risk retention in connection with the sale of assets through securitization. In addition, New Section 15G sets forth basic guidelines as to what those regulations must and may provide.

First and foremost, regulations to be issued under New Section 15G must require a "securitizer" to retain not less than 5% (which, although perhaps unlikely, leaves open the door for a higher percentage) of the credit risk for any asset that is transferred, sold or conveyed through the issuance of an "asset-backed security" by the securitizer, subject to various qualifications and exemptions, including, most notably, (1) a complete exemption for asset-backed securities collateralized solely by "qualified residential mortgages" and (2) the potential reduction of the 5% retention (including a reduction to 0%) if the "originator" meets underwriting standards for the applicable asset class indicating low credit risk (which underwriting standards are, as described below, to be prescribed as part of those future regulations). Furthermore, such future regulations are to prohibit the securitizer from directly or indirectly hedging or otherwise transferring the credit risk required to be retained, although the regulations may provide for exemptions to the prohibition on hedging.

New Section 15G defines the following terms used in the risk retention provisions:

1. "Asset-backed security" means, with limited exceptions, "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 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 [New Section 15G]."
2. "Securitizer" means "(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."
3. "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 directly or indirectly to a securitzer."

The Federal banking agencies, the SEC, the Secretary of HUD and the Director of the FHFA are to jointly define the term "qualified residential mortgage" for purposes of New Section 15G, "taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default."

In addition, the regulations to be issued under New Section 15G will specify the permissible forms of risk retention and the minimum duration of the required risk retention. The regulations will also establish various asset classes with separate risk retention rules for securitizers of different classes of assets, including residential mortgages, commercial mortgages, commercial loans, auto loans, and any other class of assets that the Federal banking agencies and the SEC deem appropriate. For each such asset class, the regulations are to include underwriting standards established by the Federal banking agencies (presumably even for non-insured depository institutions) that specify terms, conditions and

characteristics of a loan within each asset class that indicate a low credit risk. Accordingly, the amount, type, form and duration of required risk retention may well vary by asset class and credit quality of the underlying assets. Furthermore, the regulations may provide for allocation of the risk retention obligation between a securitizer and an originator from which it purchases assets.

There is a special provision for securitizations of commercial mortgages, which permits regulations for this asset class to specify that the permissible types, forms and amounts of risk retention may include:

a) retention of a specified amount or percentage of the total credit risk of the asset;
b) retention of the first-loss position by a third-party purchaser that specifically negotiates for the purchase of such loss position, holds adequate financial resources to back losses (which may relate to the likelihood that losses could render the third-party purchaser insolvent given that such purchaser would not have to actually make payments to cover such losses), provides due diligence on all individual assets in the pool before the issuance of the asset-backed securities, and meets the same standards for risk retention as required of the securitizer (which means that the third-party purchaser will be required to retain its investment for the specified duration and without the benefit of hedging);
c) a determination by the Federal banking agencies and the SEC that the underwriting standards and controls for the asset are adequate; and
d) provision of adequate representations and warranties and related enforcement mechanisms.

The regulations required to be issued under New Section 15G will become effective one year after the date of publication in the *Federal Register* for securitizations of residential mortgages and two years after publication for securitizations of all other assets. Notably, the provisions of New Section 15G would appear to require that the future implementing regulations must apply to all securitizations, regardless of whether publicly or privately issued.

Proposed SEC Rule

In the Proposed SEC Rule, which the SEC released prior to enactment of the Act, the SEC proposed to impose a risk retention requirement solely for asset-backed securities publicly offered pursuant to a shelf registration statement.[2] An effective shelf registration statement allows for the public offering of securities on a continuous or delayed basis without requiring SEC review of the offering documents for each transaction or "takedown off the shelf". Under current SEC rules, shelf registration is only available if the asset-backed securities to be offered are rated investment grade by at least one credit rating agency. The Proposed SEC Rule would repeal this requirement and replace it with four new eligibility criteria, one of which is the risk retention requirement. Pursuant to the Proposed SEC Rule, the sponsor (defined in Regulation AB as "the 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 issuing entity") or an affiliate of the sponsor will be required to retain a 5% net economic interest in the publicly offered securities through one of the following two methods: (1) retention of at least 5% of each tranche sold to investors, net of any hedge positions directly related to the securities (sometimes referred to as a "vertical slice"); or (2) for a revolving asset master trust, retention of the originator's interest of at least 5% of securitized exposures, net of any hedge positions directly related to the securities or exposures. The second retention method could presumably be satisfied, in the case of a credit card master trust, by the sponsor or an affiliate retaining a 5% *pari passu* seller interest. The SEC's commentary to the Proposed SEC Rule states that hedges related to overall market movements, such as movements of market interest

[2] The definition of asset-backed security under the Proposed SEC Rule differs somewhat from that in the Act.

rates and currency exchange rates, or of the overall value of a particular broad category of asset-backed securities, would not be interpreted as hedge positions directly related to the securities, and therefore would not be netted from the retention. The retention needs to be maintained for so long as any non-affiliates of the depositor hold any of the issuer's securities included in the offering.

The comment period for the Proposed SEC Rule ended on August 2, 2010. The SEC has not provided definitive dates for the issuance and effectiveness of a final rule, but it has stated that the time period between issuance of the final rule and its effectiveness for new transactions should not exceed one year.

Proposed FDIC Rule

The Proposed FDIC Rule was issued to replace an existing securitization safe harbor rule applicable to insured depositary institutions ("IDIs") that the FDIC issued in 2000 (12 CFR §360.6). The FDIC rule provides that the FDIC will not (a) use its repudiation power to recover financial assets transferred in a securitization so long as all GAAP sale conditions were met (other than legal isolation as applied to IDI's) and the parties intended to treat the transaction as a GAAP sale or (b) avoid an otherwise legally enforceable securitization agreement solely due to the "contemporaneous" requirement of 12 U.S.C. 1823(e).[3] Financial Accounting Statements ("FAS") 166 and 167 of the Financial Accounting Standards Board, which became effective for most companies earlier this year, effectively eliminated the ability to create non-consolidated qualified special purpose entities for most securitization transactions, with the result that very few new securitizations by IDIs will be treated as GAAP sales. As a result, most IDI securitizations can no longer benefit from the existing FDIC rule. In recognition of this fact, the FDIC has promulgated an interim rule that grandfathers securitizations by IDI's completed prior to September 30, 2010, that satisfy both the existing rule and GAAP sale treatment as in effect prior to the adoption of FAS 166 and 167.

The Proposed FDIC Rule (which would apply only to securitizations by IDIs) requires that the sponsor (defined as the person that "organizes and initiates a securitization by transferring financial assets, either directly or indirectly, including through an affiliate, to an issuing entity"[4]) retain 5% of the credit risk. The retention may be in the form of a vertical slice (5% of each credit tranche) or a representative sample of 5% of the securitized financial assets. The retention may not be transferred or hedged during the term of the securitization. The Proposed FDIC Rule does not distinguish between publicly issued or privately placed IDI securitizations in its applicability.

The comment period for the Proposed FDIC Rule expired on July 1, 2010. Unless the interim rule is extended or a final rule is issued prior to September 30, 2010, the safe harbor provision for IDI securitizations will expire on September 30, 2010.

Inconsistent Requirements

As the discussion above demonstrates, the retention provisions contained in New Section 15G and the two Proposed Rules conflict in numerous respects. Although all three retention provisions establish 5% as the baseline retention, New Section 15G contains considerably more flexibility than the two Proposed Rules. New Section 15G contemplates varying retention levels from 0% up to 5% based on the asset class and the rigor of the underwriting standards utilized, with securitizations consisting of qualified residential

[3] The "contemporaneous" requirement provides that any agreement between an IDI and a person claiming an adverse interest in property of the IDI must be executed contemporaneously with the acquisition of the property by the IDI.

[4] This is virtually identical to the definition of "sponsor" in Regulation AB.

mortgages being exempt from the retention requirement. On the other hand, the two Proposed Rules call for a fixed 5% retention regardless of asset class or underwriting standards. New Section 15G provides for potential allocation of the retention between the securitizer (which can be either the depositor or the sponsor) and the originator and (in the case of commercial mortgages) a third-party first loss purchaser. The Proposed SEC Rule provides that the retention may be held by the sponsor or an affiliate of the sponsor, but the Proposed FDIC Rule only permits the retention to be held by the sponsor. Securitizations frequently involve multiple transfers of assets, and there are often structural reasons, based on accounting, regulatory or bankruptcy considerations, for transferring whole assets (with no retention) at one level but permitting retention at another level. Allowing retention to be held by the sponsor or an affiliate (rather than just the sponsor) would permit the continuation of certain existing securitization structures without in any way reducing the "skin in the game" desired by the regulators.

New Section 15G does not specify the form of the retention, and presumably this will be something that is developed in the regulations. However, the two Proposed Rules do specify the form that retention must take. The Proposed SEC Rule permits retention in the form of a vertical slice or, for a revolving asset master trust, an originator interest, whereas the Proposed FDIC Rule allows retention in the form of a vertical slice or a representative sample of the securitized financial assets. Interestingly, in its commentary accompanying the Proposed SEC Rule, the SEC states that it considered, but rejected, the representative sample alternative, because "it would be both difficult and potentially costly for investors and regulators to verify that [the representative sample retained was] indeed selected randomly, rather than in a manner that favored the sponsor."[5] Regardless of the merits of the representative sample method, we believe that it is important that the final FDIC rule (if not subsumed or replaced by future regulations under New Section 15G, as discussed below), as well as the regulations issued pursuant to New Section 15G, include the originator interest method as a permitted form of retention, because that is a structure common in the marketplace today.

Although all three retention provisions require generally that the retention not be transferred or hedged during the term of the securitization, New Section 15G is the most flexible and the Proposed FDIC Rule is the most rigid. New Section 15G allows future regulations to provide for exemptions from the hedging prohibition. The Proposed SEC Rule only restricts hedge positions "directly related" to the securities, which would not impose limits on interest rate or currency hedges or hedges covering broad categories of ABS. The Proposed FDIC Rule, on the other hand, contains no exceptions to the prohibition on hedging. In many securitizations, the interest payments received on the underlying financial assets are based on floating rates or are subject to caps that differ from the interest rate paid on the securities, which may be fixed rate or based on different market indices. Likewise, payments on the underlying financial assets may be made in a currency that differs from the currency of the asset-backed securities. In either case, interest rate or currency hedges are commonly used. Because such hedges do not reduce the credit risk retained by a securitizer, such hedges should be permitted both by the regulations to be issued pursuant to New Section 15G and by the FDIC in any final sale harbor rule[6]. Neither New Section 15G nor the two Proposed Rules contain any exception to the prohibition on transfers. The regulations issued by the agencies should clarify that a pledge of the retained interest does not violate the prohibition on transfers,

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[5] Other practical difficulties may be inherent in the representative sample method. For example, if the sample incurs more prepayments than the securitization, the sample may fall below the required retention percentage.

[6] To the extent interest rate or currency hedges are required by rating agencies or investors as a condition to closing the securitization and are incorporated in the transaction documents, a sponsor that satisfies the risk retention requirement by acquiring a vertical slice or *pari passu* seller interest should not be viewed as hedging the retained credit risk.

at least so long as there has been no default under the pledge that would trigger a sale of the retained interest. During the recent financial crisis, IDIs were able to raise funds by pledging ABS to the Federal Reserve Bank, and it would be desirable to maintain this emergency funding source for qualifying retained interests.

Avoiding Piecemeal Regulation

Prior to the passage of New Section 15G, the SEC did not have any clear statutory mandate to adopt risk retention rules, and the SEC therefore chose to propose risk retention only for one segment of the market: ABS issued publicly under shelf registration statements. Similarly the FDIC proposed to apply risk retention rules only to the one type of issuer that it directly regulates, IDIs, in the context of confirming a safe harbor rule involving interpretation of the FDIC's powers as receiver or conservator of a failed IDI. Now that the SEC and the FDIC, together with certain other federal agencies, have the express statutory authority pursuant to New Section 15G to adopt risk retention rules, we would hope that both the SEC and the FDIC would step back from their currently proposed rules (at least with respect to risk retention matters), and work out comprehensive risk retention provisions that are not limited to a particular type of offering or issuer. In fact, it could be argued that Congress intended to mandate this approach in enacting New Section 15G and requiring a coordinated approach to its related rulemaking. Following the mandate of New Section 15G, these provisions should be calibrated for specific asset classes and should consider the nature of the underwriting, something that has not been done in the Proposed SEC Rule or the Proposed FDIC Rule. In addition, if risk retention is to apply both to publicly issued and privately placed ABS, as New Section 15G would suggest,[7] then the regulators should give clear and consistent direction on this point (since, as noted above, risk retention under the Proposed SEC Rule would only be required for publicly issued ABS using the shelf registration process). The federal agencies should in any event avoid enacting overlapping retention requirements or enacting one set of requirements this year followed by a differing set of requirements next year, because such rulemaking would result in significant additional administrative costs and uncertainty and thereby further delay the return of a healthy, working securitization market.

[7] Pursuant to clause (vi) of the definition of asset-backed security in the Act, the SEC could determine to exempt certain asset types which are securitized solely or primarily in the private placement market.

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