

SECURITIZATION REFORM IN HOUSE FINANCIAL REFORM LEGISLATION (H.R. 4173)

This client update looks more closely at the treatment of securitization in the House passed financial reform bill (H.R. 4173) summarized in our January 8, 2010 client update.

Securitization Regulation in House Bill

The House bill subtitle dealing with securitization (Title I, Subtitle F) is relatively short and provides for:

1. a risk retention requirement for (A) any transfer of a loan by a creditor who made the loan (whether or not in connection with a securitization) and (B) asset-backed securities (as such term is defined under Regulation AB)* involving assets other than loans;
2. loan-level disclosure requirements and disclosure of compensation for brokers and originators of securitized assets and the amount of risk retained by the asset originator, in each case for publicly filed asset-backed securities; and
3. regulations requiring rating agency reports to describe the representations and warranties available to investors and any departures from market standards and disclosure by issuers of the extent to which they have been forced to honor repurchase requests based on breaches.

The Risk Retention Requirement

The House bill would greatly expand the Treasury Department's proposals for securitization law reform by imposing a risk retention requirement on *any transfer of a loan*. This change was made in late October when (following negotiations with the Treasury Department) Barney Frank, Chair of the House Financial Services Committee, released a revised version of financial reform legislation that replaced most of Treasury's legislative proposal.

* Regulation AB sets forth the disclosure regime for asset-backed security public filings under the Securities Act of 1933 and the Securities Exchange Act of 1934. "Asset-backed security" is defined under Regulation AB as a "security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets . . . that by their terms convert into cash within a finite time period . . ." In order for a security to be considered an asset-backed security under Regulation AB, a number of conditions must be met, including no active management of the pool of assets, a 50% cap on delinquent assets, prohibition of non-performing assets, caps on the size of the residual values for lease pools and limits to prefunding. If a security does not meet these conditions it would not be considered an asset-backed security subject to the risk retention provisions of the House bill as it is currently drafted.

It was not clear in the subsequent Committee hearings whether the Committee or the Treasury intended the legislation to cover transfers of traditional bank loans. The plain language covers any transfer of a loan by a creditor, including possibly a transfer from one member of a bank syndicate to another, even though the loan purchaser already had an exposure to the same credit.

Chairman Frank has stated that he believes securitization was the primary cause of the financial crisis because it eliminated the link between loan origination and credit risk. It is unclear whether he believes that link must be reestablished through a risk retention requirement for all loan transfers, even those accomplished by traditional lending methods that predate the securitization market.

Under the risk retention requirement, any creditor transferring a loan would be required to retain a 5% interest unless the “appropriate agencies” (as described below) prescribe a lower retention requirement or exempt the transfer from the risk retention rules. The required risk retention may not be hedged directly or indirectly. This suggests that banks and other creditors would need to ensure that none of their dealings with a loan customer could be viewed as an effective hedge of a loan in which the bank or other creditor held a required retained interest following a transfer of that loan.

The House bill also requires securitizers of asset-backed securities (as such term is defined under Regulation AB) backed by assets other than loans to retain a material portion of the risk of the assets being securitized. It appears that the House bill is attempting to distinguish between loans, any transfer of which requires risk retention, and financial assets other than loans, for which risk retention only applies to transfers in connection with a securitization. There is some confusion in the House bill on this point, however. The term “securitizer” relates only to loans. Similarly, the 5% standard risk retention requirement only applies to loans. It is unclear, therefore, whether this is a drafting error or whether the House intended to leave for the appropriate regulators the determination of the risk retention threshold for assets other than loans.

Another curious feature of the bill is the incorporation of the definition of asset-backed securities under Regulation AB. This definition is the gate keeper for issuers seeking to take advantage of the streamlined disclosure rules for asset-backed securities, but by relying on this definition in the bill the House has exempted certain asset-backed securities from the risk retention rules. For example, the definition of asset-backed security in Regulation AB excludes securities backed by non-performing assets and pools containing delinquent loans in excess of 50%. Presumably this was not intended by the draftspersons.

Grounds for Permitting Risk Retention Reductions or Exemptions

The House bill grants the appropriate agencies the authority to provide exemptions to the risk retention requirements or to adjust the amount of required risk retention. Adjustments or exemptions must be consistent with ensuring high quality underwriting, appropriate risk management, improved consumer access to credit and serving the public interest. The bill specifically mentions that the 5% floor may be reduced or exemptions may be granted for low risk loans, such as loans that meet “certain interest rate thresholds,” that are fully amortizing or where a third party “negotiates for the purchase of the first-loss position” and diligences the entire loan pool included in the securitization.

Perhaps the most widely expressed criticism of the securitization market has been that securitizers generated loans to meet rating agency criteria and investors accepted ratings on packages of loans without conducting independent reviews. By legislating that regulators will issue rules for what constitutes a loan with reduced credit risk and proper origination or due diligence, the House bill could establish a new system in which loans are originated and then packaged to meet establish generic criteria. To the extent reductions in retention requirements (perhaps to 0%) are used to transfer loans, loan sellers would need to ensure the loan underwriting/due diligence and loan quality standards meet the regulatory criteria.

Reductions in or Exemptions from Retention Requirement For Bank Loans not Controlled by Bank Regulators

Loans insured under housing programs could be exempted from the retention requirements by the agency that oversees those programs (HUD, FHFA, or Rural Housing Service). Otherwise, all reductions in, or exemptions from, the general 5% risk retention requirement would need to be issued *jointly* by the SEC, the National Credit Union Administration Board (“NCUAB”), and the federal banking regulator for the bank using the exemption or reduction.

Why the NCUAB should be involved in decisions for financial institutions it does not oversee (unlike bank regulators, which are only involved in decisions affecting the types of banks they regulate) is unclear. It is also unclear whether this would have any impact. If the House bill became law, the NCUAB might defer to the relevant bank regulator for decisions regarding banks.

The requirement that the SEC approve any exemptions or reductions for banks could be more problematic. Historically, the SEC and bank regulators have had different views of bank loan participation and transfer markets, with each claiming jurisdiction. Court decisions have generally not treated bank loan participations or transfers as securities subject to securities laws. The new risk retention requirement may permit the SEC to exercise greater control over bank loan transfer markets. It seems unlikely the SEC would completely defer to bank regulators in granting exemptions from or reductions in risk retention requirements. This may be particularly true because the House bill places the loan transfer risk retention rules in the Securities Act of 1933, at least suggesting this is a securities law issue.

Disclosure Provisions for Publicly Registered Asset-Backed Securities; Representations and Warranties in Asset-Backed Offerings

The House bill also provides for the following with respect to asset-backed securities:

1. the Securities Exchange Act Section 15(d) reporting exemption for securities held by fewer than 300 investors and the Section 4(5) transaction exemption would be eliminated;
2. the SEC would be required to issue regulations requiring issuers subject to the reporting requirements under Section 15(d) to disclose asset-level information on a class-by-class basis; broker

and asset originator compensation; and the amount of risk retained by the originator or securitizer; and

3. the SEC would be required to prescribe regulations requiring (a) credit rating agencies to include in their credit rating reports a description of the representations and warranties (as well as enforcement mechanisms) available to investors and how they differ from those in “similar issuances” and (b) issuers to disclose “fulfilled repurchase requests” in connection with breaches of representations and warranties “so that investors may indentify asset originators with clear underwriting deficiencies.”

Mortgage Loan provisions in Other Parts of House Bill

Title VII of the House Bill regulates extensively the origination of mortgage loans. Although it provides rescission rights against assignees of loans, it exempts loans held in a securitization trust or pool. Securitizers of such loans, however, would be required to retain the right to repurchase any loan that violated Title VII's provisions from such trusts or pools.

If you would like to discuss any of the issues addressed in this Client Update or would simply like to find out more about Chapman, please contact Ken Marin at kmarin@chapman.com, Bob Lockner at lockner@chapman.com or Tim Mohan at mohan@chapman.com.

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