Client Alert

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CURRENT ISSUES RELATED TO OUR CLIENTS   AUGUST 2, 2010

Securitization Risk Retention Rules in the New Financial Regulation Law (Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010)

As we described in our July 22, 2010, client alert outlining the new financial regulation law, Subtitle D of Title IX requires regulators to establish risk retention rules for securitization transactions. This Client Alert reviews that requirement.

What Transactions Have a Risk Retention Requirement

Section 941 of the new law requires regulators to establish a risk retention requirement for any assets transferred through an asset-backed security. The new law inserts this requirement into the Securities Exchange Act of 1934 as a new section 15G of the '34 Act.

What Does Risk Retention Mean?

The new Section 15G specifies that a "securitizer" will be required to "retain an economic interest in a portion of the credit risk for any asset" transferred through a securitization. Regulators are also instructed to prohibit securitizers from hedging "or otherwise transferring" the credit risk they are required to retain. While regulators will need to specify all of this further through regulations they are required to adopt within 270 days, it is clear the intention is to make risk retention a substantive requirement, not something that can be easily avoided.

How Long Must a Securitizer Retain Such Risk?

This will be established by regulation. Section 15G instructs the regulators to specify "the minimum duration" of the required risk retention.

Does the Risk Retention Requirement Only Apply to ABS Sold in a Public Offering?

No. The original Treasury Department legislative proposal and the House bill suggested the requirement would only apply to transactions eligible for sale through Regulation AB. The new law creates a definition of asset-backed security in Section 15G of the '34 Act. That definition covers any security, not only those sold in a transaction eligible for public sale in a Regulation AB eligible transaction. Security would, for example, cover the interest in a pool of receivables transferred by the originator of those receivables to a special purpose entity.

Does the Risk Retention Requirement Apply to Loan Sales?

Only if there is a securitization of those loans. The House bill had very broad language that covered securitizations separately from loan sales and imposed a risk retention requirement on both. This language would have created a risk

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retention requirement for traditional bank participations and other forms of loan sales. The new law only applies to transfers of assets in a securitization.

Which Regulators Will Establish the Risk Retention Requirements?

The risk retention requirements must be established jointly by the SEC, the OCC, the Federal Reserve, and the FDIC. This means all four of these regulators must agree on the requirements even for parties that are not banks and for banks that are not regulated by each of the three listed "banking agencies." For the special category of "qualified residential mortgages" that will be subject to a 0% risk retention requirement, HUD and the FHFA will also need to approve the regulations establishing the definition for such mortgages.

When Will the Regulators Issue Their Regulations?

The new law states that the regulators must issue final regulations within 270 days. They will presumably issue proposed regulations soon in order to meet this timetable.

Is There a Required Percentage Risk Retention?

The new law establishes 5% as the minimum risk retention requirement unless the regulators find that the assets transferred in a securitization meet special underwriting standards.

Is 5% the Maximum Risk Retention Requirement?

Not necessarily. While the new law states the required risk retention is at least 5%, unless special underwriting standards are met, it does not prevent regulators from establishing a higher requirement in general or for specific types of transactions.

Can Regulators Permit No Risk Retention for a Securitization?

Yes. In fact, the regulators are required to establish a 0% risk retention requirement for a securitization of "qualified residential mortgages." "Qualified residential mortgage" is to be defined by regulations, taking into account underwriting and product features that historical data indicate should result in a lower risk of default, such as verification of assets, borrower income and mortgage insurance at the time of origination. Regulators also will have the discretion to establish a 0% risk retention requirement for any other assets that present a "low credit risk."

The special 0% risk retention requirement will not apply to any securitization of "qualified residential mortgages" that is a securitization of a separate securitization of such mortgages. Thus, CDOs and any other securitization of ABS made up of qualified residential mortgages must have a risk retention requirement.

The proposed revisions to Regulation AB and the FDIC's proposed securitization safe harbor rule, both of which are currently in their comment period, are inconsistent with Dodd-Frank in their risk retention requirements. First, each proposed rule contains a minimum 5% risk retention requirement without differentiating between asset types or exempting qualified mortgages. Second, the retained risk must be from a "vertical slice" of the assets sold (i.e. a portion of each credit tranche or a pro rata portion of all the assets, as opposed to retention of the equity tranche or residual interest), whereas the Dodd-Frank legislative requirement leaves the structure of retention to the regulators. There is no requirement in the legislation that the SEC and the FDIC reconcile the risk retention requirements under Reg AB and the safe harbor, respectively, with the regulations adopted in connection with the legislation.

Can Regulators Exempt Transactions?

Yes. The regulators can both establish risk retention requirements below 5%, including 0% risk retention requirements, and completely exempt specific types of transactions.

Does the Law Exempt Certain Transactions?

Yes. Regulators have no authority to apply any risk retention requirement to government guaranteed or government insured loans (which does not include Fannie Mae or Freddie Mac) nor to obligations of the Federal Agricultural Mortgage Corporation or of any other entity supervised by the Farm Credit Administration.

Will the New Regulations Be Effective When They are Issued?

No. The new law requires regulators to issue final regulations in 270 days. For mortgages, those regulations will only be effective one year after they are issued in final form. For all other assets, the final regulations will only be effective two years after they are issued. This means no transaction will be covered by a risk retention requirement until late 2011, at the earliest. More likely, mortgage transactions will be subject to the new rules sometime in 2012 and other assets sometime in 2013.

If you would like to discuss any of the issues addressed in this Client Alert or would simply like to find out more about Chapman, please contact any member of our Asset Securitization Group or the Chapman attorney with whom you usually work, or visit us at chapman.com.

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