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The Simple Life: A Look at Securitization Related Regulatory Reform Proposals

It's not about Paris Hilton and Nicole Ritchie—at least not this time. It's maybe more along the lines of that other great duo's (Emerson's and Thoreau's) credo, the "return to simplicity" movement. Only this time it's simplicity and mortgage-backed securities. Historically, those were not two things that one would have put together in the same phrase. But, we're getting ahead of ourselves. Over the past two years, the nation has faced what has been described as the most severe financial crisis since the Great Depression. Subprime mortgages originated and then sold in "securitization" vehicles in the secondary market have been blamed as being one of, or the principal, cause of the problem. Maybe that's enough to have shocked some into advocating in favor of "plain vanilla" and simple structures. On June 17th, the Obama Administration released its white paper, titled "Financial Regulatory Reform: A New Foundation," which proposes fundamental reforms to the financial regulatory system, including reforms that would affect the regulation of mortgages and the secondary mortgage market. The mortgage-related reforms include:

- Creation of a Consumer Financial Protection Agency ("CFPA") to protect consumers by authorizing the CFPA to regulate the providers of financial products and services, including mortgage loan originators, and to administer and enforce these regulations;
- Reforms with respect to the future of the Government Sponsored Entities ("GSEs"); and
- Reforms with respect to securitizations, including requiring mortgage originators or sponsors to retain 5% of the credit risk of a mortgage pool sold to investors; the promulgation of additional regulations to align compensation of market participants with longer term performance of underlying loans; changes with respect to methods of accounting in securitizations; and increased reporting and disclosure requirements on asset-backed securities.

In addition to the proposals set forth in the white paper, there are a number of other pending reforms and proposals that affect or may affect securitizations, including changes to methods of accounting with respect to securitizations and proposed legislation to facilitate the creation of a covered bond market.

The Consumer Financial Protection Agency

The white paper proposes the creation of a single federal agency, the CFPA, dedicated to protecting consumers in the financial products and services markets, including the mortgage market. This entity, however, would not regulate investment products and services already regulated by the Securities and Exchange Commission or the Commodities Futures Trading Commission. The Administration proposes to create such an agency because of potential gaps and weaknesses in consumer protection that have come to light during the financial crisis.

The CFPA would appear to be a super-regulator of consumer financial products and services. It would have broad authority, including authority to regulate, administer, and enforce regulations relating to financial products and services. The CFPA would have authority to:

- Regulate consumer financial products offered by nonbank institutions;
- Promulgate regulations and enforce consumer protection laws applicable to banks;
- Regulate mortgage companies that are not owned by banks (and which are outside the current consumer regulatory structure);
- Promulgate (and have the sole authority to promulgate) and interpret regulations under statutes such as the Truth in Lending Act, Home Ownership and Equity Protection Act, Real Estate Settlement and Procedures Act, Community Reinvestment Act, Equal Credit Opportunity Act, Home Mortgage Disclosure Act, and the Fair Debt Collection Practices Act; and
- Supervise compliance and enforce any regulatory violations.

The Administration proposal would repose in the CFPA special regulatory authority with respect to the mortgage loan market, including regulation of more exotic products, which are blamed in the white paper for having caused some of the challenges faced by mortgage borrowers. The CFPA would have the authority to:

- Require that all disclosures and other communications with respect to financial products and services to consumers be adequate, simple, fair, and reasonable in order to ensure that consumers of such products understand and can manage the risks associated with such products;
- Encourage the development of "plain vanilla" products (*e.g.*, fixed and adjustable rate mortgages), which would carry a presumption of suitability and affordability for the borrower;
- Discourage exotic products (*e.g.*, alternative mortgages and negative amortization mortgages), which would not carry a presumption of suitability and affordability, while preserving choice and innovation. Originators of such products would be subject to significantly higher penalties for any violations of the law;
- Regulate unfair, deceptive, or abusive acts or practices, by, for example, having the authority to ban prepayment penalties and yield spread premiums (*i.e.*, side payments to mortgage originators that are tied to the borrower's receiving worse terms than the borrower could qualify for); and
- Impose a duty of care on financial intermediaries (*e.g.*, the CFPA could impose on mortgage brokers a fiduciary duty to provide the best available mortgage loan and a duty to determine affordability).

The Administration envisions the CFPA's "strong" rules to serve as a floor, and not as a ceiling. States would have the ability to adopt and enforce stricter laws. In addition, the Administration proposes that states have concurrent authority to enforce CFPA regulations.

The creation of a federal agency dedicated to consumer protection with respect to financial products and services may be viewed by some to be a step in the right direction. Unfair and abusive mortgage practices have been well documented during the last two years. In addition, a single body to promulgate and interpret rules and regulations under the morass of statutes already dedicated to consumer protection should provide greater certainty and simplicity in the law. However, with any course of action, there may be disadvantages. For example, increased regulation (including potential additional regulations by each and every state) on mortgages may increase costs of compliance, which may ultimately be borne by the consumer. In addition, the delicate balance of protecting the consumer through increased regulation while preserving choice and innovation may be difficult to achieve in any practical sense. Accordingly, the Administration's intent to encourage homeownership may become more difficult to achieve for certain potential borrowers.

The Future of the Government Sponsored Entities

In response to a deepening housing crisis and speculation regarding the failure of Fannie Mae and Freddie Mac, on July 30, 2008, Congress passed the Housing and Economic Recovery Act ("HERA"). HERA granted the United States Treasury the authority to place Fannie Mae and Freddie Mac into conservatorship, (ii) increased regulatory oversight over the GSEs, and (iii) increased the conforming loan limits of the GSEs to $625,000 from $417,000 (to provide liquidity in the mortgage market by allowing the GSEs to purchase additional mortgages and to reduce interest rates on such mortgages over time). The U.S. Treasury placed the GSEs in conservatorship in September 2008. The GSEs have taken an even greater role in the secondary mortgage market in order to preserve the stability of the financial and mortgage markets; however, this increased role is intended to be temporary. The future role of the GSEs' is uncertain. The white paper states that the Administration will report to the Congress at the time of the 2011 budget to determine their futures. The white paper puts forward various options for GSE reform, including:

- Returning GSEs to their prior status with the paired interests of maximizing returns for private shareholders and pursuing public policy home ownership goals;
- Gradual wind down of their operations and liquidation of their assets;
- Incorporating the GSEs' functions into a federal agency;
- A public utility model where the government regulates the GSEs' profit margin, sets guarantee fees, and provides explicit backing for GSE commitments;
- Conversion to providing insurance for covered bonds; and
- The dissolution of Fannie Mae and Freddie Mac into smaller companies.

The option to liquidate the GSEs or dissolve the GSEs into smaller companies would be a fundamental policy shift. Over 40 years ago, Congress directed the GSEs to expand the secondary mortgage market, and they have done so. The GSEs are the dominant players in this market, accounting for more than half of the market share of U.S. residential mortgage loans. The effect of liquidation of the GSEs on the secondary mortgage market would likely be significant. For example, one would expect mortgage costs for borrowers to increase, which would discourage homeownership, which is contrary to one of the Administration's objectives.

The option to convert the GSEs to providing insurance for covered bonds is interesting. Covered bonds are a form of financing in which an investor has a priority interest in the underlying collateral (*i.e.*, the mortgage) and also has recourse against the issuer of the covered bond. It is a form of on-balance sheet financing. The prior administration issued a series of guidance regarding covered bonds, with the intent to facilitate the creation of such a market (for more details in respect of such guidance, *see, e.g.*, "Covered Bonds and U.S. Regulators," available at http://www.mofo.com/news/updates/files/CoveredBondsUSregulator.pdf), "FDIC Offers Certainty on Covered Bonds," available at http://www.mofo.com/docs/pdf/Client_Alert_FDIC.pdf), and "Treasury Announces Best Practices for Covered Bonds," available at http://www.mofo.com/news/updates/files/080729TreasuryAnnounces.pdf). Many of the problems identified, and solutions proposed, by the white paper with respect to securitizations do not apply to covered bonds. For example, issuers of covered bonds generally retain "skin in the game," thereby making the 5% retention rule (discussed in more detail below) unnecessary.

Securitization Reforms

While noting the benefits of securitization, the white paper finds fault with the current securitization model. According to the white paper, the current securitization model has led to a general erosion of lending standards, resulting in our current financial crisis, particularly due to the complexity and conflicts of interest that exist among securitization participants, including originators, sponsors, servicers, mortgage brokers, credit agencies, and investors.

The white paper proposes to address these perceived failings with five general recommendations:

- Federal banking agencies should promulgate regulations that require originators or sponsors to retain an economic interest in a material portion of the credit risk of securitized credit exposures.
- Regulators should promulgate additional regulations to align compensation of market participants with longer term performance of the underlying loans.
- The SEC should continue its efforts to increase the transparency and standardization of securitization markets and be given clear authority to require robust reporting by issuers of asset-backed securities.
- The SEC should continue its efforts to strengthen the regulation of credit rating agencies, including measures to promote robust policies and procedures that manage and disclose conflicts of interest, differentiate between structured and other products, and otherwise strengthen the integrity of the ratings process.
- Regulators should reduce their use of credit ratings in regulations and supervisory practices, wherever possible.

<u>The 5% Retention Rule</u>. The white paper proposes that federal banking agencies promulgate regulations that require loan originators or sponsors to retain 5% of the credit risk of the mortgage pool sold to investors. The white paper further proposes to prohibit an originator or sponsor from directly or indirectly hedging or otherwise transferring the risk it is required to retain. The requirement of a retained interest is intended to ensure that the originator and/or sponsor of a securitization continue to have "skin in the game" in the form of ongoing exposure to the credit risk of the underlying mortgage pool. The theory is that having "skin in the game" will improve mortgage loan underwriting standards.

The 5% rule raises a number of issues in its scope, application, and policy. For example, it is not entirely clear:

- Whether the 5% would help foster investor confidence in securitizations, as investors will still have to take 95% of the credit risk of the pool.
- How the 5% rule will affect the mortgage market, as many institutions retained credit risk relating to the mortgages they issued, leading to their ultimate collapse when the mortgages soured. For example, it is not clear the extent to which the 5% rule will increase costs to mortgage borrowers or decrease mortgage loan originations. Presumably, additional costs will ultimately be passed onto borrowers, and mortgage originations will generally be reduced.
- Whether the mortgage originator or sponsor (or both) would have to hold 5% of the first loss piece, or a *pro rata* share of each class of interest sold to investors from the mortgage pool, or whether the requirement could be satisfied through a guarantee or other form of credit enhancement; in addition, the duration of the holding period required with respect to such interests is also unclear. These issues are generally left to the regulators to determine.
- Whether mortgage originators or sponsors could hedge with a member of an affiliated group, or if the rule is limited to hedging arrangements outside of the affiliated group.
- How the 5% rule would be accounted for on the books of the originator or sponsor—that is, at book value or at "fair value," requiring periodic mark-to-market adjustments. Also, there may be questions regarding the impact of the retention on the originator's and/or sponsor's ability to derecognize, or treat as sold, the 95% securitized interest under the new Financial Accounting Standards Board ("FASB") pronouncements, Statement No. 166 and Statement No. 167, which substantially revise the sale and consolidation principles previously embodied in Statement No. 140 and FASB Interpretation No. ("FIN") 46(R), as discussed in more detail below.

Align Compensation Over Life of Loan. The white paper proposes that the compensation of loan brokers, originators, sponsors, underwriters and others involved in the securitization process be linked to the longer term performance of the securitized assets, rather than only to the production of those products. For example, the proposal states that the fees and commissions received by loan brokers and loan officers, who otherwise have no ongoing relationship with the loans they generate, should be disbursed over time and should be reduced if underwriting or asset quality problems emerge over time. The proposals to compensate individuals and other transaction participants, such as underwriters, over time will likely be extremely difficult to administer in an industry where compensation is traditionally paid currently. The white paper is vague on how these changes would be implemented. It remains to be seen what type of administrative infrastructure and payment clearinghouse would need to be established to track workers' entitlements to compensation over the life of a long-term loan. In addition, the servicing cost of applying performance criteria and dividing loan payments among brokers, underwriters and others may be considerable relative to the presumably small amounts involved.

Changes to Methods of Accounting. The white paper also proposes that the immediate recognition of income, or gain on sale, by originators at the inception of a securitization be eliminated under GAAP, and that originators should instead be required to recognize income over time. It also states that many securitizations should be consolidated on the originator's balance sheet and their asset performance should be reflected in the originator's consolidated financial statements. Many of the accounting changes suggested by the white paper with respect to originators are already under discussion by the accounting profession or have already been incorporated in the newly issued FASB pronouncements, Statement No. 166 and Statement No. 167, as discussed in more detail below.

Additional Reporting and Disclosure Requirements. The recommendations pertaining to reporting and disclosure and to regulation of the credit rating agencies are already being actively pursued by various securitization industry regulators and constituencies. It is not entirely clear what, if anything, the proposals would seek to add in addition to what is already being pursued by such regulators and constituencies.

Statement No. 166 and Statement No. 167

On June 12, 2009, the Financial Accounting Standards Board published Financial Accounting Statements No. 166, *Accounting for Transfers of Financial Assets,* and No. 167, *Amendments to FASB Interpretation No. 46(R),* which modifies how entities account for securitizations and special-purpose entities. (These statements, and concise summaries of these statements, are available at www.fasb.org). The new standards are generally effective beginning in 2010.

Statement No. 166 revises Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Under Statement No. 140, in general, if an entity qualified as a "qualifying special-purpose entity" ("QSPE"), consolidation of the QSPE with the transferor of financial assets was not required. A transfer of all or a portion of a financial asset was eligible for sale status if certain derecognizing criteria were met. In addition, special provisions applied allowing a transferor to classify interests received in a guaranteed-mortgage securitization ("GMS") transaction as available-for-sale or trading securities under Statement No. 115. In general, Statement No. 166 revises Statement No. 140 by eliminating the concept of a QSPE, changes the requirements for derecognizing financial assets, and removes the special provisions with respect to GMS transactions to require those securitizations to be treated the same as any other transfer of financial assets within the scope of Statement No.140, as amended, among other things.

Statement No. 167 revises FIN 46(R), *Consolidation of Variable Interest Entities,* by changing how a company determines when certain entities ("variable interest entities") should be consolidated for accounting purposes. In general, a variable interest entity is an entity that is thinly capitalized or an entity in which investors lack voting or similar rights. In general, Statement No. 167 revises FIN 46(R) to require an enterprise to perform a qualitative analysis (rather than a quantitative analysis) in order to determine whether the enterprise's variable interest or interests give it a controlling financial interest in the entity. Commentators had previously argued that a quantitative analysis was too complex. Statement No. 167 also removes the QSPE exception from FIN 46(R).

Statements No. 166 and No. 167 generally make it more difficult to achieve off-balance sheet treatment for securitization transactions. These Statements will also likely have a significant effect on existing securitization transactions, which may have to be consolidated. For example, those relying on the QSPE exception could no longer rely on that exception to avoid consolidation.

U.S. Covered Bond Legislation

As discussed in our prior client alert on covered bonds (*see* "U.S. Covered Bond Legislation Introduced in Congress," available at http://www.mofo.com/news/updates/files/090617Bond.pdf), on June 16, 2009, Republican Representative Scott Garrett and Democratic Representative Paul E. Kanjorski jointly introduced a bill in the U.S. House of Representatives to enact the "Equal Treatment of Covered Bonds Act of 2009."

The proposed legislation would provide a statutory definition of the term "covered bond" and would include "covered bonds" as an enumerated type of "qualified financial contract," or "QFC," entitled to expedited, favored treatment upon the conservatorship or receivership of a financial institution. The statute's purpose is to ensure that investors receive, in a single, liquidated payment, the value of their foregone interest and any reinvestment losses.

It appears that covered bonds are being seriously considered by policymakers as an alternative to securitizations. The benefit of covered bonds over securitization transactions include, in addition to avoiding many of the problems recognized by the white paper with respect to securitization transactions, the ability to have a dynamic pool of collateral (referred to as the "cover pool"), which allows the mortgage originator or sponsor to actively maintain the pool, as opposed to securitizations which are generally locked down after startup. In addition, the new proposals generally reduce the benefits of securitizations over covered bonds (*e.g.*, off-balance sheet treatment for accounting purposes), thereby potentially tilting the pendulum in favor of covered bonds as a primary source of financing U.S. mortgages.

Conclusion

The white paper contains a number of recommendations, some more controversial than others and some more likely to be implemented than others. The recommendations in respect of securitization seem to add up to the proposition that simpler is better. As for simplicity in this context, a cautionary note may be in order. While many of these measures may appear to provide benefits to investors and borrowers, most impose economic or liability burdens on originators, servicers and sponsors of securitizations that, at the margin, make it less likely that an originator will choose to pursue a securitization strategy, or may increase the costs of mortgage loans for borrowers. This, in turn, may discourage homeownership, which is contrary to an objective of the Administration. Accordingly, some economic studies of the effects of the various proposals would be useful.

Paris and Nicole or Ralph Waldo and Henry David may have demonstrated that simple has its place. However, it is far from intuitively obvious that this is the case for the mortgage origination and finance model of the future.

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