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Conference Committee Securitization Reform

On June 25, 2010, the joint House of Representatives-Senate Conference Committee finalized the securitization provisions of the federal financial reform bill (the "Conference Bill"). The Conference Bill will now be presented to the House of Representatives and the Senate and is expected to be approved quickly.

The Conference Bill is similar to the Senate's proposed "Restoring American Financial Stability Act of 2010" (the "Senate Bill") with some modifications. The securitization provisions of the Conference Bill, like predecessor bills, focuses on "credit risk retention" that would require originators and securitizers of financial assets to retain a portion of the credit risk of securitized financial assets or, in more popular terms, to have "skin in the game." In addition, securitization provisions in the Conference Bill set forth disclosure requirements for the issuer and credit rating agencies who rate the issuer's securities.

Amount of Risk Retention

The Conference Bill generally requires credit risk retention of 5% of any asset included in a securitization, or less than 5% if the assets meet underwriting standards established by regulation. Risk retention requirements also will be required for collateralized debt obligations, securities collateralized by collateralized debt obligations, and similar instruments collateralized by other asset-backed securities. The Conference Bill prohibits a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset unless regulations to be adopted specify otherwise. The Conference Bill also requires the Chairman of the Financial Services Oversight Council to study the macroeconomic effects of the risk retention requirements, with emphasis placed on potential beneficial effects with respect to stabilizing the real estate market.

Allocation of Risk Retention

The Conference Bill imposes risk retention requirements in the first instance upon securitizers (that is, issuers and sponsors of securitizations), but allows regulators to allocate the risk retention percentage between the securitizer and the originator of the underlying financial assets. This is a fixed-sum game—regulators must reduce the risk retention percentage imposed on a securitizer by the percentage imposed on the originator. The Conference Bill also sets forth factors that the regulators must consider in determining the respective percentages of risk retention to be borne by securitizers and originators, such as whether the assets sold to the securitizer have terms, conditions, and characteristics that reflect low 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 securitizer; and the potential impact of the risk retention obligations on the access of consumers and businesses to credit on reasonable terms.

Asset Class Differentiation

Under the Conference Bill, underwriting standards and the amount of risk retention may be different for different asset classes as determined by regulation. The Conference Bill specifies the asset classes to be treated separately as residential mortgages, commercial mortgages, commercial loans, auto loans and any other asset class that the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC") and the Securities and Exchange Commission ("SEC") deem appropriate. The Conference Bill sets forth standards for regulators to consider when determining risk retention forms, types and amounts for commercial mortgages, including permitting a third party that purchases a first-loss position at issuance and who holds adequate financial resources to back losses substituting for the risk retention requirement of the securitizer.

Exemptions

The Conference Bill exempts "qualified residential mortgages" from the risk retention provisions. Regulators will be responsible for defining what constitutes a "qualified residential mortgage," provided that the definition shall not be broader than the definition of the same term under the Truth in Lending Act. In making the determination as to what constitutes a "qualified residential mortgage," regulators shall consider underwriting and product features that historical loan performance data indicate result in a lower risk of default, such as (i) documentation and verification of the financial resources relied upon to qualify the mortgagor; (ii) standards with respect to the residual income of the mortgagor after all monthly obligations, the ratio of the housing payments of the mortgagor to the monthly income of the mortgagor, and the ratio of total monthly installment payments of the mortgagor to the income of the mortgagor; (iii) mitigating the potential for payment shock on adjustable-rate mortgages through product features and underwriting standards; (iv) mortgage guarantee insurance or other types of insurance or credit enhancement obtained at the time of origination, to the extent such insurance or credit enhancement reduces the risk of default; and (v) prohibiting or restricting the use of balloon payments, negative amortization, prepayment penalties, interest-only payments, and other features that have been demonstrated to exhibit a higher risk of borrower default.

The Conference Bill provides regulatory authority to grant a total or partial exemption from the risk retention provisions for any securitization of assets issued or guaranteed by the U.S. government or U.S. government agencies, as well as any securitization of assets issued or guaranteed by a state or by any political subdivision of a state or territory, or by any public instrumentality of a state or territory that is exempt from the registration requirements of the Securities Act of 1933 by reason of section 3(a)(2) of that Act, or a security defined as a qualified scholarship funding bond in section 150(d)(2) of the Internal Revenue Code of 1986. Also exempt from the risk retention requirements are any assets made, insured, guaranteed, or purchased by any institution that is subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation, and any residential, multifamily, or health care facility mortgage loan asset, or securitization based directly or indirectly on such an asset, which is insured or guaranteed by the U.S. government or a U.S. government agency. However, assets issued or guaranteed by Fannie Mae, Freddie Mac or the federal home loan banks are not exempt.

The Conference Bill also provides regulatory authority to grant a total or partial exemption for any securitization, as may be appropriate in the public interest and for the protection of investors; provided that any exemption, exception, or adjustment adopted or issued by the federal banking agencies and the SEC shall help ensure high-quality underwriting standards for the securitizers and originators of assets that are securitized or available for securitization, and encourage appropriate risk management practices by the securitizers and originators of assets and improve the access of consumers and businesses to credit on reasonable terms.

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Regulatory Agencies

The Conference Bill gives primary responsibility for issuing implementing regulations to the OCC, the Board of Governors of the Federal Reserve System, the FDIC, and the SEC. Similarly, the OCC, the Board of Governors of the Federal Reserve System and the FDIC are given enforcement authority with respect to risk retention requirements over bank securitizers, while the SEC is given enforcement authority over non bank securitizers. The Secretary of Housing and Urban Development and the Director of the Federal Housing Finance Agency will also have authority with respect to regulations relating to residential mortgages.

Disclosure

The Conference Bill provides for regulations to require securitizers to disclose, for each tranche or class of security, information regarding the assets backing that security. Disclosure shall include asset-level or loan-level data, if such data are necessary for investors to independently perform due diligence, including (i) data having unique identifiers relating to loan brokers or originators; (ii) the nature and extent of the compensation of the broker or originator of the assets backing the security; and (iii) the amount of risk retention by the originator and the securitizer of such assets. The Conference Bill also provides for regulations to require securitizers to disclose both fulfilled and unfulfilled repurchase requests so that investors may identify asset originators with clear underwriting deficiencies. In addition, the Conference Bill requires credit rating agencies to include in any report accompanying a credit rating a description of the representations, warranties, and enforcement mechanisms available to investors, and how these differ from the representations, warranties, and enforcement mechanisms in issuances of similar securities.

Due Diligence

The Conference Bill requires issuers of asset-backed securities to perform due diligence on the underlying financial assets and to disclose the nature of that analysis in their registration statements.

Effective Date

Credit risk retention regulations must be prescribed within 270 days of the passage of the Conference Bill by the House of Representatives and the Senate. Once prescribed, the new regulations would become effective for residential mortgage-backed securities one year after adoption of final regulations, and for other asset classes two years after adoption of final regulations.

The Big Picture

It is still too early to predict the shape of the securitization market of the future. The Conference Bill is only one reform measure that will impact the securitization industry and many of its provisions require regulators to promulgate rules within 270 days from the date of enactment. Until the various agencies begin releasing proposed rules, it is difficult to determine the impact that the Conference Bill, if passed in its current form, will have on the industry. The reform measures that have had the greatest impact on the industry have been the Financial Accounting Standards Board's adoption of Financial Accounting Statements 166 and 167 ("FAS 166," and "FAS 167," respectively). The change in accounting standards impacted bank capital and leverage requirements, as well as treatment of certain bank assets in the event of a FDIC conservatorship or receivership. Banking agencies have already addressed issues raised by FAS 166 and FAS 167 by revising their risk-based capital and leverage rules and the FDIC is proposing amendments to its "securitization rule" safe harbor to require financial institutions to retain more of the credit risk from securitizations and to set new standards for meeting the legal isolation requirement. In addition, the SEC is proposing sweeping changes to Regulation AB that will impact the registration, disclosure and reporting requirements for asset-backed securities and other structured finance products. We will continue to monitor the various proposals and the release of proposed rules required once Congress passes financial reform legislation.

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Contacts

Melissa D. Beck
(212) 336-4319
mbeck@mofo.com

Jerry R. Marlatt
(212) 468-8024
jmarlatt@mofo.com

Kenneth E. Kohler
(213) 892-5815
kkohler@mofo.com

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