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MEMORANDUM

TO: CMSA

FROM: Scott A. Sinder
Rhonda M. Bolton

SUBJECT: Administration's Legislative Proposal to Revise Regulation of Securitization Market

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Overview

The Treasury Department has released draft legislative language that would effect the changes for securitization markets that were proposed in the Obama Administration's June 2009 "blueprint" for financial regulatory reform. As previously reported, the overall goal of the proposed securitization market reforms, according to the blueprint, is to better align the interests of securitization market participants with longer term performance of the underlying loans.

The legislative language circulated by Treasury is largely consistent with the concepts that were outlined in the blueprint. Of particular interest to CMSA, the legislation would require securitizers to retain 5% of the credit risk of any asset underlying an asset-backed security (ABS) the securitizer sells to a third party, and would prohibit the securitizer from hedging risk associated with its retained interest. Regulators would, however, have the ability to grant exceptions to these requirements. The most notable aspect of the draft legislation is that it sheds some light on the criteria that must be met to obtain an exception, although the criteria are described in somewhat amorphous terms: an exemption must—

- "help ensure high quality underwriting standards for securitizers and originators of assets; and
- facilitate appropriate risk management practices by such securitizers and originators, improve access of consumers to credit on reasonable terms or otherwise serve the public interest."

These criteria do not, on their face, exclude the possibility of obtaining an exemption for B-piece buyers. However, it may be prudent to seek an amendment of the language to clarify that the structure of a CMBS deal, with the presence and role of the B-piece buyer that assumes the first-loss position, is precisely the category of asset or deal structure that should be exempted. The goal would be to make it difficult, if not impossible, for the regulatory agencies to decline to grant an exemption to CMBS.

One aspect of the securitization language that did not previously appear in the blueprint is elimination of the SEC registration exemption for certain commercial and mortgage-backed securities, which was contained in Section 4 of the Securities Act of 1933 (15 U.S.C. § 77d (5)).[1] There does not appear to be any significance to the loss of this exemption but it is unclear why the exemption was removed.

The other aspects of the legislation are disclosure of asset or loan level data (for which the SEC also may grant an exemption), and requirements concerning representations and warranties for the ABS market that would compel credit rating agencies to describe available representations, warranties, and enforcement mechanisms for investors and any distinctions in this regard from similar issuances, and would require disclosure of fulfilled repurchase requests across all trusts by originator, for the purpose of allowing investors to "identify asset originators

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[1] The exemption applied to "(A) promissory notes directly secured by a first lien on a single parcel of real estate upon which is located a dwelling or other residential or commercial structure, and participation interests in such notes (i) where such securities are originated by a savings and loan association, savings bank, commercial bank, or similar banking institution which is supervised and examined by a Federal or State authority, and are offered and sold subject to the following conditions:

(a) the minimum aggregate sales price per purchaser shall not be less than $250,000;

(b) the purchaser shall pay cash either at the time of the sale or within sixty days thereof; and

(c) each purchaser shall buy for his own account only; or

(ii) where such securities are originated by a mortgagee approved by the Secretary of Housing and Urban Development pursuant to 12 U.S.C. §§ 1709 and 1715b and are offered or sold subject to the three conditions specified in subparagraph (A)(i) to any institution described in such subparagraph or to any insurance company subject to the supervision of the insurance commissioner, or any agency or officer performing like function, of any State or territory of the United States or the District of Columbia, or the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, or the Government National Mortgage Association;" and the exemption applied to

"Transactions between any of the entities described in subparagraph (A)(i) or (A)(ii) involving non-assignable contracts to buy or sell the foregoing securities which are to be completed within two years, where the seller of the foregoing securities pursuant to any such contract is one of the parties described in subparagraph (A)(i) or (A)(ii) who may originate such securities and the purchaser of such securities pursuant to any such contract is any institution described in subparagraph (A)(i) or any insurance company described in subparagraph (A)(ii), the Federal Home Loan Mortgage Corporation, Federal National Mortgage Association, or the Government National Mortgage Association and where the foregoing securities are subject to the three conditions for sale set forth in subparagraphs (A)(i)(a) through (c)."

with clear underwriting deficiencies." We note that the draft legislative language does not propose that ABS sponsors provide investors with any particular representation or warranty, as had originally been suggested in the blueprint.

The proposed securitization language is discussed in more detail below.

Credit Risk Retention Requirements and Exemption Authority

Treasury's legislative proposal for securitization markets has three components, the first of which addresses credit risk retention requirements. The Federal banking regulators and SEC are directed to jointly prescribe regulations requiring a securitizer to retain an economic interest in "a material portion" of the credit risk for any asset that the securitizer, through the issuance of ABS, sells or transfers to a third party. The legislation then sets forth particular requirements that must be contained in the risk retention rules. The rules must –

1) prohibit hedging or transferring of the retained risk, whether directly or indirectly;

2) require the securitizer to retain "at least" 5 percent of the credit risk; note that the legislation sets a floor on the retained risk amount, so regulators could adopt rules requiring more;

3) specify the permissible forms of risk retention to be required (e.g., first loss position or pro rata vertical slice) and the minimum duration of the required risk retention;

4) provide for the allocation of risk retention obligations between a securitizer and an originator in cases where a securitizer purchases assets from an originator, as may be appropriate;

5) apply regardless of whether the securitizer is an "insured depository institution" within the meaning of the FDIC Act, which of course means the rules' application will not be limited to securitizers who are banks;

6) provide for a total or partial exemption for securitizations of assets issued or guaranteed by the United States, an agency of the United States, or a United States Government-sponsored enterprise, as may be appropriate; and,

7) provide for "a total or partial exemption of other securitizations as may be appropriate in the public interest or for the protection of investors."

The legislative proposal then goes on to place parameters around the agencies' exemption authority. "Exemptions, exceptions, or adjustments" can be made to the risk retention and hedging requirements for "classes of institutions or assets." And, any exemption that is adopted must

- "help ensure high quality underwriting standards for securitizers and originators of assets; and

- facilitate appropriate risk management practices by such securitizers and originators, improve access of consumers to credit on reasonable terms or otherwise serve the public interest."

These exemption criteria do not explicitly preclude the possibility of obtaining an exemption for B-piece buyers, as previously explained. But neither are they completely clear. Accordingly, an amendment should be considered to clarify that ABS that already are structured with a risk retention component, but which may involve sale of the retained risk to another entity that has conducted its own due diligence – like CMBS – satisfy the legislation's goal and should be exempted.

As for enforcement, although the banking regulators and SEC are directed to jointly develop the risk retention regulations, enforcement is divided such that the SEC will oversee the risk retention requirements for all entities other than insured depository institutions.

Reporting Requirements

The second component of Treasury's securitization language requires the SEC to adopt a rule mandating that ABS issuers disclose, for each tranche or class of security, information regarding the assets backing the security. At a minimum, the SEC must require disclosure of asset-level or loan-level data "necessary for investors to independently perform due diligence," and such data must include "unique identifiers relating to loan brokers or originators, the nature and extent of the compensation of the broker or originator of the assets backing the security, and the amount of risk retention of the originator or the securitizer of such assets."

Significantly, the SEC is authorized to suspend or terminate this reporting requirement for any class of ABS issuer as "appropriate in the public interest or for the protection of investors." This provides an opening to seek relief from such a reporting requirement where it would otherwise violate SEC regulations or confidentiality agreements.

Requirements Concerning ABS Representations and Warranties

Finally, Treasury's proposal would touch upon the representations and warranties associated with ABS, although we note that the proposal does not require sponsors to make any particular type of representation or warranty to investors, as had been suggested in the Administration's blueprint. Rather, the legislation would require disclosure of fulfilled repurchase requests across all trusts aggregated by originator, for the purpose of allowing investors to "identify asset originators with clear underwriting deficiencies." In addition, the proposal would require credit rating agencies to describe in their reports the representations, warranties, and enforcement mechanisms for investors that are available, and how they "differ from representations, warranties, and enforcement mechanisms in similar issuances."