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June 17, 2009

TO: CMSA

FROM: Scott A. Sinder
Rhonda M. Bolton

RE: Obama Administration Plan to Overhaul Financial Regulation

This afternoon, the White House released its formal proposal for reforming financial services regulation that President Obama described in his remarks as a “sweeping overhaul of the system” that would institute “transformation not seen since the great depression.” The 85 page document is a compendium of proposals with very high level descriptions of what they intend to try to accomplish, but with very few specifics. The Administration identifies five key, overarching objectives:

- (1) Promote robust supervision and regulation of financial firms;
- (2) Establish comprehensive supervision of financial markets
- (3) Protect consumers and investors from financial abuse
- (4) Provide the government with the tools it needs to manage financial crises
- (5) Raise international regulatory standards and improve international cooperation.

While the devil will of course be embedded in the final details, there is much that can be gleaned from what is included in the broad brush strokes of today's "Blueprint 2" for reform. The proposal includes significant reforms directed at securitization which could have a broad impact on the commercial capital markets including, most significantly –

- New risk retention requirements for originators ("skin in the game");
- Measures purportedly designed to align compensation with long-term performance of securitized assets;
- Accounting rule changes to eliminate the originators' immediate recognition of "gain on sale" in favor of reflecting income as the assets perform over time, and requiring consolidation on originators' balance sheets;
- Changes in the regulation of credit rating agencies with respect to structured products, including differentiation of ratings for structured products; and
- New securitization disclosure and reporting requirements, including document standardization requirements.

More broadly, the proposal will completely change the government's philosophy toward regulating financial institutions, creating new regulatory authorities to foster oversight on a systemic basis to replace the more fragmented model now in place. For institutions that are deemed systemically significant, there will be enhanced oversight regardless of whether the institution owns a bank, and that authority will include the ability to take over and wind down any failing institution. New consumer protection initiatives along with a strong federal consumer protection regulator are part of the plan. And finally, the plan expresses a sense of urgency in strengthening and harmonizing international financial regulation, including the harmonization of international accounting standards.

A more detailed discussion of some of the securitization-related components of the proposal is below.

Analysis

I. Changes Proposed for the Securitization Markets

A. Proposal Context/Background

The white paper states that “[t]he financial crisis was triggered by a breakdown in credit underwriting standards in subprime and other residential mortgage markets.... enabled by lax or nonexistent regulation of nonbank mortgage originators and brokers” and “a broad relaxation in market discipline on the credit quality of loans that originators intended to distribute to investors through securitizations rather than hold in their own loan portfolios.”

This declaration is important because its specific citation of developments in the residential market should be a basis for the CMBS sector to argue against application of some of the proposals to the commercial sector. Indeed, it appears that a number of the Administration’s specific regulatory proposals have applicability in the residential, as opposed to the commercial, context. As the process goes forward to develop legislation to effect the proposal, every opportunity should be taken to distinguish the commercial market from residential, and to educate policymakers on the safeguards that the commercial market already has in place that should obviate the need for the high degree of scrutiny the Administration proposes.

B. The Regulatory Proposal for Securitization Markets

Enhanced regulation of the securitization markets is proposed as part of the Administration’s broader goal of establishing comprehensive regulation of financial markets. The stated purpose of regulating securitization in the manner proposed is to fix a “breakdown in market discipline” by changing the incentive structure of market participants, increasing transparency, strengthening credit rating agency performance, and reducing over-reliance on

credit ratings. Substantively, the specific proposals for regulation can be thought of as falling under each of these purposes.

1. Changing the incentive structure of market participants.

Because the Administration believes that one of the most significant problems in the securitization markets is “lack of incentives for lenders and securitizers to consider the performance of the underlying loans after asset-backed securities (“ABS”) were issued,” the Administration seeks to:

- Require loan originators and sponsors to retain five percent of the credit risk of securitized exposures, and prohibit the originator from directly or indirectly hedging or otherwise transferring the risk it is required to retain. Federal banking agencies (which are not identified at this point) would have the authority to specify permissible forms of required risk retention, such as first loss position or pro rata vertical slice. The agencies would also have the authority to provide exceptions or adjustments to risk retention requirements. The proposal also goes on to explain that regulators should have the authority to apply the retention requirements to sponsors rather than loan originators to achieve the alignment of incentives contemplated by the proposal;
- Link compensation of brokers, originators, sponsors, underwriters, and others involved in the securitization process to long-term performance of the securitized assets rather than only to the production of the ABS;
- Changing the Generally Accepted Accounting Principles (GAAP) to eliminate the immediate recognition of “gain on sale” by originators at the time of a securitization transaction, and instead require originators to reflect income as the assets perform over time;
- A change to the accounting standards to require that “many” securitizations be consolidated onto the “originator’s” balance sheet; it is not clear whether this recommendation is identical to the consolidation requirements recently imposed by FASB, or whether the Administration’s proposal is narrower;
- Structuring securitization fees so they “enhance incentives for focusing on underwriting, for example, disbursing loan broker and loan officer fees and commissions over time and reducing the commissions if underwriting problems emerge (this is a measure that seems much more focused on the residential side); and

- Requiring sponsors to provide investors with assurances, in the form of “strong, standardized representations and warranties,” regarding the risk associated with the origination and underwriting practices for the underlying loans.

2. Increasing Transparency.

Coupled with the problematic incentive structure, the Administration opines that inadequate disclosure regimes exacerbated the gap in incentives between lenders, securitizers and investors. The proposal accordingly would:

- Give the SEC “clear authority” to require “robust” ongoing reporting by ABS issuers, and direct the SEC to continue efforts to improve and standardize disclosure practices by originators, underwriters and credit rating agencies involved in securitization;
- Require ABS issuers to disclose loan level data, and the nature and extent of broker, originator and sponsor compensation and risk retention. It is not clear to whom the disclosures would be made;
- Expand the Trade Reporting and Compliance Engine, the standard trade reporting database for corporate bonds, to include ABS; and
- The Administration urges the industry to complete its standardization initiatives and also make legal documentation for securitization more transparent, including the admonition to the residential market that its standards should involve “clear and uniform rules for servicers to modify mortgages.” This is yet another directive that is not (or should not be) applicable to the commercial side.

3. Strengthening credit rating agency performance.

The Administration makes several proposals to enhance credit rating agency (“CRA”) performance, recognizing that the SEC had already begun to adopt new rules governing credit rating agencies. Most troubling, one of the specific Administration proposals appears to reverse the SEC’s decision last fall not to require differentiation of ratings for structured products, in addition to several other new requirements for CRA with respect to structured products, and other new disclosure and conflict-of-interest requirements:

- CRAs will report on their credit rating performance measures for structured credit products to allow comparison across products and ratings and adequately display the uncertainty and potential volatility associated with credit ratings;
- CRAs will publicly disclose additional information about the methodology used to rate structured finance products (e.g. asset-backed securities);
- CRAs will publicly disclose what risks their ratings are designed to assess and provide this information in a way that is easy to understand;
- CRAs must maintain “robust policies and procedures” for managing and disclosing conflicts of interest; and
- CRAs will be required to disclose non-public rating agency data and methodologies to the SEC.

II. Other Reforms

As mentioned, the proposal seeks to completely change the government’s approach to regulating financial institutions, and institutions involved in the CMBS market could be affected by the broader reforms particularly if, for example, they are deemed systemically significant. Such entities will be subject to enhanced oversight regardless of whether they own a bank, and they will be subject to government takeover if they are in danger of failing.

It is anticipated that the new consumer protection initiatives announced, such as the new federal consumer financial protection agency, would affect entities that deal directly with consumers, such as those involved in the residential mortgage sector, rather than entities that do not deal with consumers.

Finally, it should be noted that the Administration’s plan directs some degree of attention to harmonizing international financial regulation, including the harmonization of international accounting standards. The Administration’s goals in this regard may be of particular interest since CMSA has also advocated for international accounting harmonization. Among the plan’s relevant statements are recommendations that:

- Accounting standard setters clarify and make consistent the application of fair value accounting standards, including the impairment of financial instruments, by the end of 2009;
- Make “substantial progress” by the end of 2009 toward the development of a single set of global standards; and
- Make loan loss provisioning standards more forward looking as long as transparency of financial statements is not compromised.

* * *

As mentioned, legislation to effect the Administration’s proposals has not yet been introduced. We will continue to monitor for developments including the drafting of legislation.