ALSTON+BIRD LLP

Financial Services and Products ADVISORY

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Dodd-Frank Wall Street Reform and Consumer Protection Act Overview of Title IX, Subtitle D: Relevant Securitization Provisions

Summary

Yesterday, after a vote in favor of a cloture motion, the U.S. Senate voted 60-39 to pass landmark financial reform legislation entitled the ''Dodd-Frank Wall Street Reform and Consumer Protection Act'' ("H.R. 4173" or the "Act").[1] Certain provisions of the Act will substantially impact issuers of asset-backed securities (ABS), underwriters and future securitization transactions. In particular, Title IX, Subtitle D, is intended to enhance transparency and disclosure and reduce certain perceived risks associated with ABS transactions. This advisory provides a brief overview of some of the key provisions of the Act that relate to securitization reform.

Five Key Features

1. Defines "asset-backed security."
2. Imposes a risk retention requirement referred to by industry participants as "skin in the game."
3. Increases disclosure and reporting requirements for ABS issuers.
4. Enhances representations and warranties in securitization documentation.
5. Enhances due diligence and disclosure requirements.

Regulation of Credit Risk Retention

Definition of "asset-backed security"

The Act defines an "asset-backed security" as a "fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset" that includes a collateralized mortgage obligation (CMO), collateralized debt obligation (CDO), collateralized bond obligation (CBO), collateralized debt obligation (CDO) of an ABS, CDO of CDO, and any other security determined by the U.S. Securities and Exchange Commission (SEC) to be an ABS.

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1 *See* Conference Base Text (HR 4173), http://www.alston.com/files/docs/h4173.pdf.

The definition of "asset-backed security," however, *does not include* a "security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company."

Credit Risk Retention

The Act requires that no later than 270 days after its enactment:

- The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC) (together, the "Federal Banking Agencies") and the SEC must jointly prescribe rulemaking that will require any securitizer to retain an economic interest in a portion of the credit risk for any asset that the securitizer,[2] through the issuance of an ABS, transfers, sells or conveys to a third party.

- The Federal Banking Agencies, the SEC, the Secretary of Housing and Urban Development (HUD), and the Federal Housing Finance Agency (FHA) must jointly prescribe rulemaking that will require any securitizer to "retain an economic interest in a portion of the credit risk for any residential mortgage asset" that the securitizer, through the issuance of an ABS, transfers, sells or conveys to a third party.

Key Criteria

The Act prescribes the criteria that must be addressed in the substance of the rulemaking that the regulators adopt.

Two key requirements are:

- the prohibition of a securitizer from directly or indirectly hedging or otherwise taking any action that seeks to transfer the credit risk that the securitizer is required to retain with respect to the asset; and

- the requirement that the securitizer retain "not less than 5 percent of the credit risk for any asset" other than a Qualified Residential Mortgage (as defined below) or less than 5 percent of the credit risk for an asset that is not a Qualified Residential Mortgage that is transferred, sold or conveyed through the issuance of an ABS by the securitizer if the originator of the asset meets certain underwriting standards to be prescribed.

In the rulemaking that is adopted, regulators must specify:

- the permissible forms of risk retention;

- the minimum duration of the risk retention;

- in the case of ABS that are classified as Qualified Residential Mortgages, that the securitizer is not required to retain any part of the credit risk;

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2 Subtitle D of Article IX of the Act defines "securitizer" to mean (a) an ABS issuer or (B) a person who organizes or initiates an ABS transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.

- that the credit risk retention requirements must apply regardless of whether the securitizer is an insured depository institution;
- with respect to commercial mortgages, the permissible types, forms and amounts of risk retention that would qualify such as:
  - retention of a specified amount or percentage of the total credit risk of the asset;
  - retention of the first-loss position by a third-party purchaser that specifically negotiates for the purchase of such first loss position, that holds adequate financial resources to back such losses, provides due diligence on all individual assets in the pool before the issuance of the ABS and meets the same standards that the regulators may require of a securitizer;
  - a determination by the Federal Banking Agencies and the SEC that the underlying underwriting standards and controls for the assets are adequate;
  - provision of adequate representations and warranties and related enforcement mechanisms in the underlying transaction documents; and
  - appropriate standards for retention of an economic interest with respect to a CDO, securities collateralized by CDOs and similar instruments collateralized by other ABS.

The regulators must also specify in the rulemaking that is adopted:

- the total or partial exemption of any securitization, "as may be appropriate in the public interest and for the protection of the investors";
- the total or partial exemption for the securitization of an asset issued or guaranteed by the United States or an agency of the United States as deemed appropriate by the Federal Banking Agencies and the SEC (the Act specifies, however, that for purposes of this clause, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation are not agencies of the United States);
- the total or partial exemption for any ABS issued or guaranteed by any state or political subdivision of a state that is exempt from registration under the Securities Act of 1933 pursuant to Section 3(a)(2) or a security defined as a "qualified scholarship funding board" in Section 150(d)(2) of the Internal Revenue Code; and
- the allocation of risk retention obligations between a securitzer and an originator in the case of a securitizer that purchases assets from an originator, as deemed appropriate by the Federal Banking Agencies and the SEC.

Asset Classes

The Act specifies that the regulations adopted must establish separate rules for securitizers of different asset classes. For each separate asset class, the regulations must prescribe underwriting standards established by the Federal Banking Agencies that specify the terms, conditions and characteristics of a loan within such asset class that indicate a low credit risk with respect to the loan.

Originators

The Act requires that the regulations adopted must reduce the percentage of risk retention obligations for a securitizer by the risk retention obligations of the originator[3] and consider:

- 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 securitization"; and
- the "potential impact of the risk retention obligations on the access of consumers and businesses to credit on reasonable terms, which may not include that transfer of credit risk to a third party."

Exemptions, Exceptions and Adjustments

The Act provides that the Federal Banking Agencies and the SEC may jointly adopt or issue exemptions, exceptions or adjustments to the rules issued for "classes of institutions" or "assets relating to the risk retention requirement and the prohibition of hedging."

Any exemption that is provided for must:

- ensure enhanced "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, improve the access of consumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors."

Under the Act, the following institutions, programs and asset types are exempt:

- Farm Credit System Institutions (including the Federal Agricultural Mortgage Corporation);
- Any residential, multifamily or health care facility mortgage loan asset, or securitization based directly or indirectly on an asset that is insured or guaranteed by the U.S. government or a U.S. agency (for purposes of this exemption, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and the federal home loan banks are not considered U.S. agencies); and
- Qualified Residential Mortgages.

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[3] Subtitle D of Article IX of the Act defines "originator" to mean a person who "through the extension or credit or otherwise, creates a financial asset that collateralizes an asset-backed security and sells an asset directly or indirectly to a securitizer."

For purposes of the exemption, the Federal Banking Agencies, the SEC, the Secretary of Housing and Urban Development and the Director of the Federal Housing Finance Agency must jointly define the term “Qualified Residential Mortgage.” In doing so, the regulators must take into consideration certain underwriting and product features that “historical loan performance data indicate result in a lower risk of default” such as:

- documentation and verification of the financial resources relied upon to qualify the mortgagor;
- standards with respect to (1) residential income of the mortgagor after all monthly obligations; (2) the ratio of the housing payments of the mortgagor to the monthly income of the mortgagor; and (3) the ratio of total monthly installment payments of the mortgagor to the income of the mortgagor;
- mitigating the potential for payment shock of adjustable rate mortgages through product features and underwriting standards;
- mortgage guarantee insurance or other types of insurance or credit enhancement obtained at the time of origination, to the extent such features reduce the risk of credit default; and
- 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 definition of Qualified Residential Mortgage is subject to the following conditions:

- the definition should be no broader than such term defined in the Truth in Lending Act Section 129C(c)(2), as amended by the Consumer Financial Protection Act of 2010, and regulations adopted thereunder;
- an ABS that is collateralized by tranches of other ABS shall not be exempt from the risk retention requirements;
- each issuer will be required to certify to the SEC, for each issuance of an ABS collateralized exclusively by Qualified Residential Mortgages, that such issuer has evaluated the effectiveness of the internal supervisory controls of the issuer with respect to the process for ensuring that all assets that collateralize the ABS are QRM.

Enforcement and Effectiveness

The regulations issued pursuant to this section will be enforced by:

- the appropriate Federal Banking Agency with respect to any securitizer that is an insured depository institution; and
- the SEC with respect to any securitizer that is not an insured depository institution.

The rules will take effect:

- for ABS backed by residential mortgages, one year after the final rules published in the Federal Register; and
- for other ABS asset classes, two years after the final rules are published in the Federal Register.

Credit Risk Retention Study

Within 90 days after the Act's enactment, the Board of Governors of the Federal Reserve System must submit to Congress a report prepared in coordination with the Comptroller of the Currency, the Director of the Office of Thrift and Supervision, the Chairperson of the FDIC and the SEC, that evaluates the combined impact of each individual class of ABS established under section 15G(c)(2) of the Securities Exchange Act of 1934 and takes into consideration:

- the new credit risk retention requirements (including the effect credit risk retention requirements have on increasing the market for Federally subsidized loans); and
- the Financial Accounting Statements 166 and 167 issued by the Financial Accounting Standards Board.

Disclosures and Reporting Obligations for Asset-Backed Securities

Reporting

Amends Section 15(d) of the Securities Exchange Act of 1934 to provide that reporting is not automatically suspended for ABS when there are fewer than 300 securityholders at the fiscal year end, and allows the SEC to specify when such suspension can occur for any class of ABS.

Disclosure

The SEC must adopt regulations requiring ABS issuers to disclose, for each tranche or class of security, information regarding the assets backing that security. The regulations adopted should include:

- standards for the format of the data provided by ABS issuers that will allow for comparison of such data across securities of similar asset classes;
- requirements for ABS issuers, at a minimum, to disclose asset-level or loan-level data, if such data is necessary for investors to independently perform due diligence including:
    - data having 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 by the originator and the securitizer of such assets.

Enhanced Representations and Warranties in Asset-Backed Offerings

Within 180 days after the Act's enactment, the SEC must prescribe regulations on the use of representations and warranties in ABS transactions. Such regulations must require:

- each nationally recognized statistical rating organization (NRSRO) to include in any report a description of the representations and warranties and enforcement provisions available to investors;

- a description of how such representations, warranties and enforcement mechanisms differ from issuances of similar securities; and
- securitizers to disclose "fulfilled and unfulfilled repurchase requests across all trust aggregated by the securitizer, so that investors may identify asset originators with clear underwriting deficiencies."

Due Diligence Analysis and Disclosure in Asset-Backed Securities Issues

Amends the Securities Act of 1933 to require that 180 days after the Act's enactment, the SEC issue rules relating to the registration statement required to be filed by any ABS issuer. Such rules must require an issuer to:

- perform due diligence analysis of the assets underlying the ABS; and
- disclose the nature of such analysis.

Study on the Macroeconomic Effects of Risk Retention Requirements

The Chairman of the Financial Services Oversight Council must conduct a study on the macroeconomic effects of the risk retention obligations with an emphasis on the potential beneficial effects with respect to stabilizing the real estate market. The study must also include an analysis of:

- the effects of the risk retention on real estate asset price bubbles (including a retrospective estimate of what fraction of real estate losses may have been averted had such requirements been in force in the recent years);
- the feasibility of "minimizing the real estate price bubbles by proactively adjusting the percentage of risk retention that must be borne by creditors and securitizers of real estate debt, as a function of regional or national market conditions";
- a comparable analysis for proactively adjusting mortgage origination requirements;
- whether such proactive adjustments should be made by independent regulation, or in a formulaic and transparent manner;
- whether such adjustments should take place independently or in concert with monetary policy; and
- recommendations for implementation and enabling legislation.

Conflicts of Interest

The Act also amends the Securities Act of 1933 to prohibit sponsors, underwriters or placement agents of ABS, or affiliates of such entities, from engaging "in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity." The prohibition against such activity will apply for one year after the closing date of the sale and provides for certain exceptions that relate to "risk-mitigating hedging activities," intended to enhance liquidity.

Alston & Bird will be publishing a comprehensive summary on the enacted financial reform legislation shortly.

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