Impact of the Obama Administration's Financial Regulatory Overhaul on the Securitization Markets

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September 8, 2009

On June 24, 2009, we published an article generally describing the Obama Administration's plan to substantially reform the regulation of the financial markets (the Plan). A fundamental aspect of the Plan relates to enhanced supervision and regulation of the securitization markets. In the Plan, the Obama Administration lays part of the blame for the current financial crisis at the hands of various securitization market participants, including (i) loan originators, whose lax underwriting standards failed to require sufficient documentation of borrower income and ability to repay debts, (ii) securitizers, who failed to set high standards for the loans they were willing to buy, thus encouraging lax underwriting standards by the loan originators, (iii) investors, who were overly reliant on the ratings assigned by the credit rating agencies, and (iv) credit rating agencies, whose ratings often failed to accurately describe the risk of rated products.

Securitization Market Recommendations

The Plan proposes the following five key (and somewhat vague) reforms to address the perceived failings of the securitization markets:

1. ***Require Limited Risk Retention***. The Plan calls for federal banking agencies to promulgate regulations that require loan originators or sponsors to retain 5% of the credit risk of securitized exposures, without the ability to hedge or otherwise transfer the risk of such exposure. According to the Plan, this step is critical to prevent "gaming of the system" to undermine the economic tie between the originator and the asset-backed securities. The Plan suggests that the federal banking agencies should have the authority to specify the permissible forms of risk retention (i.e., a first loss position or a *pro rata* vertical slice) and the minimum duration for such risk retention. In addition, those agencies would have the authority to make exceptions or adjustments to those requirements on an "as needed" basis. There is no indication that the risk retention requirement would be limited to federally regulated banks and it appears that it would apply to both public offerings and private placements of asset-backed securities (ABS). The risk retention requirement could have the unintended effect of increasing (rather than decreasing) the risk to financial institutions that originate or sponsor securitization transactions and may also lead to increased regulatory capital charges for such institutions.
2. ***Tie Compensation to Performance***. The Plan encourages regulators to adopt additional regulations to align compensation of market participants with longer term performance of the securitized assets, rather than only to the production, creation or inception of those products. As an example, the Plan references a change in U.S. GAAP (as currently proposed by FASB in FAS 166 and 167) to eliminate the immediate recognition of gain upon sale by originators at the inception of a securitization transaction and instead require them to recognize income over time. In addition, the Plan proposes that fees and commissions be disbursed to loan brokers and loan officers over time (rather than at origination) and be subject to reduction if underwriting or asset quality problems arise over time. It is not clear how such reductions would be effected or who would be responsible for effecting them. Furthermore, the Plan recommends that sponsors of securitization transactions be required to make "strong" standardized representations and warranties to investors with respect to risks associated with the origination and underwriting practices for the securitized loans, although it is not clear how such representations and warranties would differ from those in existing securitization transactions.
3. ***Increase Market Transparency***. The Plan recommends that the SEC continue its efforts to increase the transparency and standardization of securitization markets and be given clear authority to require robust reporting by issuers of ABS. According to the Plan, investors and credit rating agencies should have access to the information necessary to assess the credit quality of securitized assets at inception and over the life of the transaction, as well as the information necessary to assess the credit, market, liquidity and other risks associated with ABS. The Plan does not specify what data, beyond that already required by Regulation AB, should be required to be provided. It does, however, recommend that ABS issuers disclose loan-level data (broken down by loan broker or originator) and the nature and extent of broker, originator and sponsor compensation and risk retention for each securitization. The Plan also calls for greater

standardization and transparency of securitization transaction agreements so that market participants can make informed investment decisions, without providing specific detail on how this should be accomplished. Finally, the Plan recommends that the SEC and FINRA expand the Trade Reporting and Compliance Engine (TRACE), the standard trade reporting database for corporate bonds, to include ABS.

4. ***Increase Regulation of Credit Rating Agencies***. The Plan advises the SEC to continue its efforts to strengthen the regulation of credit rating agencies, including the adoption of 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. Many industry participants, including investors, have voiced opposition to any requirement that structured products such as ABS receive different ratings than those assigned to corporate bonds, a proposal that the SEC rejected when it finalized the 2009 Rating Agency Reform Act Amendments. Notably, the Plan does not seek to impose additional liability on the credit rating agencies for the quality of their work or require them to change the current "issuer pays" model, which has been widely criticized for misaligning incentives among credit rating agencies and those that utilize their rating services.
5. ***Reduce Reliance on Credit Ratings***. The Plan proposes that regulators should reduce their use of credit ratings in regulations and supervisory practices, wherever possible. However, the Plan does not seek to eliminate the quasi-regulatory role that ratings play in establishing legal investment, regulatory capital and other regulatory criteria. In fact, the Plan would require that risk-based regulatory capital requirements appropriately reflect the risk of structured credit products and minimize opportunities for companies to use securitization as a means of reducing regulatory capital requirements without a corresponding reduction in risk.

Creation of Consumer Financial Protection Agency

In addition to the foregoing recommendations, the Plan proposes the creation of an independent Consumer Financial Protection Agency (CFPA) to regulate providers of credit, savings, payment and other consumer financial products and services and otherwise to protect consumers who purchase these products. Mutual funds and other investment products and services that are already regulated by the SEC or Commodity Futures Trading Commission (CFTC) would fall outside the scope of the CFPA's jurisdiction. Significantly, the Plan would seek to reverse long-standing principals of federal banking law preemption by subjecting federally chartered banks to both regulation and enforcement by states in addition to the CFPA.

Also, the CFPA would have supervisory authority to examine compliance by regulated institutions, including federally regulated banks and other non-bank financial institutions that were not previously subject to comprehensive federal supervision and regulation. The CFPA would be authorized to require providers of financial products to be reasonable, clear and balanced in their presentation of costs, risks and benefits of acquiring the financial products or services being offered.

Although the Plan would consolidate federal consumer protection regulatory authority in the CFPA, it would greatly expand the role of the states in consumer protection. The states would be permitted to enact stricter laws and regulations, which would apply both to state and federally chartered institutions. In addition, the states would have the right to enforce not only their own consumer protection laws, but also the federal laws promulgated by the CFPA, even against federally chartered entities. This will impose a significant regulatory burden on national banks, which will be forced to devote substantial efforts to state-by-state regulatory compliance.

Proposed Legislation

On July 21 and July 22, 2009, the Obama Administration proposed legislation to implement certain of the securitization and rating agency reform proposals contained in the Plan. A copy of the proposed legislation as it relates to securitization reforms is here. A copy of the proposed legislation as it relates to rating agency reforms is here.

Securitization Reforms. The proposed legislation with respect to securitization reforms would (i) implement the provisions of the Plan mandating 5% risk retention by both bank and non-bank securitizers (defined as issuers or underwriters of ABS), (ii) increase disclosure and periodic reporting requirements by issuers of ABS, and (iii) call for the SEC to implement regulations regarding the use of representations and warranties in ABS offerings.

Noticeably absent from the proposed securitization legislation were several of the Plan's other recommendations, such as those related to compensation linkage and GAAP accounting changes. It is not clear whether the Obama Administration intends to defer or forgo the implementation of those recommendations or, in the case of GAAP accounting changes, leave them up to the FASB.

Rating Agency Reforms. The proposed legislation with respect to rating agency reforms would (i) require credit rating agencies to register with the SEC and become subject to the oversight of a newly-created office within the SEC that would be charged with administering SEC rules with respect to the practices of rating agencies and conducting annual reviews of credit rating and policies, procedures and methodologies of the credit rating agencies, (ii) implement various measures designed to prevent conflicts of interest and other perceived deficiencies in the ratings process, (iii) require public disclosure of initial ratings and subsequent changes to such ratings so that the users of credit ratings may compare the performance of ratings by different rating agencies, and (iv) require the SEC to promulgate a form to accompany each rating issued by a credit rating agency that would disclose certain qualitative and quantitative information that is designed to help investors and other users of credit ratings to better understand the meaning of such ratings. The proposed legislation would also require the SEC to adopt rules mandating that the credit rating agencies differentiate the credit ratings assigned to structured and non-structured credit products, a measure that has been strongly opposed by many market participants.

Andrews Kurth remains committed to keeping the business community informed about developments in the securitization market. If you would like more information about these developments, please Mark Harris, Pat Sargent, David Barbour, Muriel McFarling, Paul Sève, Mike Jewesson or your Andrews Kurth contact.