

# ClientAlert

## Financial Markets Developments

July 2010

### Dodd-Frank Wall Street Reform and Consumer Protection Act

## Credit Risk Retention and Other Modifications Affecting Asset-Backed Securitizations

Subtitle D of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") sets forth substantive criteria which regulators are required to incorporate in rules to be promulgated which are aimed at improving the asset-backed securitization process. The basic aim of this subtitle of the Act is to address the problem that arises when the person who makes an initial extension of credit (e.g., a mortgage loan, a loan through use of a credit card, a loan for the purchase of an automobile, etc.) is not the same person who ultimately bears the risk of the loan's repayment and, therefore, does not have the same incentive to ensure repayment as a person who holds the loan until maturity. In fact, when the originator of a loan earns fees based upon the number of loans originated, the loan originator's financial incentive may be to maximize the number of loans originated without regard to ultimate repayment of the loans originated. Thus, the Act and the new rules required by it are intended to more closely align the economic interests of securitizers and their investors and to improve underwriting standards of financial assets when a securitizer issues an asset-backed security (sometimes called "ABS").

The Act uses two primary methods of improving the securitization process. First, it requires a person involved in a securitization to retain exposure to the credit risk of the initial loan, thereby theoretically incentivizing the securitizer to create higher quality financial assets to ensure a higher likelihood of repayment. Second, the Act mandates the creation of underwriting standards for the financial assets that may be securitized. In other words, if holding the credit risk of the assets is not enough of an incentive to create high quality financial assets, then the rules issued by regulators will be used to ensure the creation of high quality financial assets that are securitized. In addition, the Act also includes provisions to promote additional due diligence on the securitized assets by originators, investors and third-party service providers.

As the asset-backed securities market is highly complex, the Act reflects an understanding by Congress (or at least a political compromise to the effect) that it is not able to knowledgeably regulate the ABS market. As one reads Subtitle D, it is striking how little is achieved by the text of the Act and the magnitude of delegation to the Securities Exchange Commission (the "SEC"), the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation ("FDIC") (the latter three, collectively, the "Federal banking agencies" and, together with the SEC, the "Regulators"). Almost every definitive requirement has an exception or carve-out of some type that allows the Regulators to adopt rules that significantly modify the requirements set forth in the Act. The resulting law leaves a huge amount of uncertainty as to how particular types of securitizations will ultimately be affected by the Act.



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## 1. What types of securities are covered by the Act?

The Act's definition of "asset-backed security"<sup>1</sup> includes both fixed income securities and other securities "collateralized by any type of self-liquidating financial asset." While the term "financial asset" is not defined in the Act, the definition of "asset-backed security" uses broad language to describe the concept and lists a few examples of financial assets including: a loan, a lease, a mortgage or a secured or unsecured receivable. The security also must be one that "allows the holder of the security to receive payments that depend primarily on the cash flow from the asset[.]" Specific types of asset-backed securities are enumerated as a non-exclusive list within the definition. The definition does not apparently include securities for which the credit is based on the liquidation value (i.e., the market value) of the asset collateralizing the security.

## 2. Who is subject to the risk retention requirement?

The Act requires either the "securitizer"<sup>2</sup> or the "originator"<sup>3</sup> to retain exposure to the credit risk of the securitization or the assets securitized. A securitizer is either an issuer of the securities or a person who organizes and initiates an ABS transaction by selling or transferring assets to the issuer. An originator is a person who creates a financial asset who also sells the financial asset to a securitizer.

The Act initially assigns the obligation of risk retention to the securitizer,<sup>4</sup> but ultimately allows the Regulators to determine how risk retention is allocated by dividing the required risk retained between the securitizer and the originator.<sup>5</sup>

## 3. What is the amount of risk retention requirement?

The Act generally establishes an explicit five percent target, but the target does not provide a complete answer. The amount of credit risk that a securitizer is required to retain with respect to an asset that collateralizes asset-backed securities will ultimately be set forth in the regulations adopted by the Regulators and will depend on the type of asset and the underwriting standards used by the originator of such asset. On the face of the Act, a securitizer is required to retain **at least** five percent of the credit risk of any asset that is not a qualified residential mortgage<sup>6</sup> and **at least** five percent of the credit risk of a qualified residential mortgage if the asset-backed securities secured by such qualified residential mortgage are also secured by one or more assets that are not qualified residential mortgages.

The five percent risk retention requirement may be reduced, however, for an asset that is not a qualified residential mortgage if the originator of the asset used underwriting standards that meet the standards for the asset set by the Federal banking agencies.<sup>7</sup> In addition, the Act reduces the amount of risk required to be retained by a securitizer by the amount of risk allocated by the Regulators (in regulations to be adopted) to the originator from which the securitizer purchased the assets, after the Regulators consider:

- Whether the assets sold to the securitizer reflect low credit risk.
- Whether the form or volume of securitization transactions in the markets incentivizes poor underwriting standards.
- The potential impact of risk retention obligations on consumer and business access to credit on reasonable terms.<sup>8</sup>

Thus, the amount of retained credit risk for any asset type will ultimately be determined by the Regulators (including additional regulators in the case of mortgage ABS).<sup>9</sup> The explicit five percent risk retention requirement set forth in the Act will no doubt serve as a firm and public target for much of the high volume ABS issuances. For the exact effects of the risk retention requirement on specific types of ABS and on each institution, the market must wait until the Regulators speak more definitively on the topic.

## 4. In what form are securitizers required to retain credit risk and for how long?

The Act does not specify a required form of risk retention or a minimum time period for which securitizers must retain such risk. Instead, the Act again leaves it to the Regulators to decide the appropriate form and duration of the risk retention requirement. With respect to commercial mortgage backed securities, however, the Act specifies that the rules promulgated by the Regulators may allow the risk retention requirement to be satisfied by a sophisticated third party that negotiates and purchases the first-loss position.<sup>10</sup>

With the Regulators establishing the form of risk retention, the views of two of the Regulators (the SEC and the FDIC) provide some insight into the potential outcome of the risk retention requirements. For example, earlier this year the SEC issued a release proposing widespread changes to transactions involving asset-backed securities and other structured finance products.<sup>11</sup> The Proposed SEC Securitization Rules include a proposal for a risk retention requirement as part of the criteria to establish eligibility for delayed shelf offerings of asset-backed securities.

Under the Proposed SEC Securitization Rules, the risk retention requirement would apply to sponsors<sup>12</sup> and would be satisfied by the sponsor retaining either (i) a minimum of five percent of the nominal amount of each of the tranches of asset-backed securities sold to investors (i.e., a “vertical slice” of the credit risk), or (ii) in the case of a securitization of revolving assets such as credit card receivables, a minimum of five percent of the originator’s interest in the nominal amount of the securitized assets. The risk retention requirement would be measured at issuance and would be required to be maintained on an ongoing basis. In the Proposed SEC Securitization Rules, the SEC rejected the idea of requiring “horizontal risk retention” in the form of retention of the residual interest of a securitization because, in the SEC’s view, the only way to ensure that a sponsor and investors have a direct, shared interest is to require the sponsor to take a portion of the economic risk of each class of securities offered. However, by requiring a sponsor to retain an economic interest in each class of securities, the sponsor’s aggregate economic interest would be distinct from other investors in any one class of securities as only the sponsor would have an economic interest at other levels in the capital structure.

Although the Act does not distinguish between private and public offerings, it is interesting to note that, in the Proposed SEC Securitization Rules, the SEC did not apply the risk retention requirement to private offerings of asset-backed securities, which represent a significant portion of the ABS market.

In a proposed rule,<sup>13</sup> the FDIC reached a similar conclusion to the SEC:

The FDIC believes that the sponsor must be required to retain an economic interest in the credit risk relating to each credit tranche or in a representative sample of financial assets in order to help ensure quality origination practices. A risk retention requirement that did not cover all types of exposure would not be sufficient to create an incentive for quality underwriting at all levels of the securitization.<sup>14</sup>

Thus, the FDIC and the SEC, two of the four regulators involved in the determination of the form of credit risk, share a similar view that a “vertical slice” approach is more consistent with a diligent underwriting of financial assets. A vertical slice of the securitization credit risk, so the theory goes, removes any incentive for a securitizer either to favor a tranche or to place additional risk on a tranche.

## 5. Can a securitizer hedge retained credit risk?

The Act prohibits securitizers from hedging or otherwise transferring the credit risk required to be retained with respect to any securitized asset.<sup>15</sup> The Act, however, does not include such a prohibition on originators, but presumably an originator could also be a securitizer in many situations and such a restriction could be applied through regulations issued to permit the sharing of risk retention between securitizers and originators. Again, there is the possibility of an exemption, exception or adjustment for a class of institutions or a class of securities, as described below in more detail.<sup>16</sup>

## 6. What authority do regulators have to grant exemptions to the risk retention requirement and the risk-hedging restriction?

The Act allows the Regulators to adopt rules creating exemptions from or exceptions to the credit risk retention requirement, including the prohibition on hedging.<sup>17</sup> Any such exemptions or exceptions are required to assist in ensuring that securitizers and originators use high-quality underwriting standards, encourage appropriate risk management practices by securitizers and originators and improve access to business and consumer credit on reasonable terms, or otherwise be in the interest of the public and for investor protection.<sup>18</sup> The Act includes a number of specific exemptions from the risk retention requirement, including:

- qualified residential mortgages (except where the related asset-backed securities are collateralized by (i) assets other than qualified residential mortgages or (ii) other tranches of asset-backed securities, even if the underlying collateral for such asset-backed securities is qualified residential mortgages);<sup>19</sup>
- securitizations of assets issued or guaranteed by the US government or an agency thereof, (but excluding the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”));<sup>20</sup>
- financial assets made, insured, guaranteed or purchased by any institution subject to the supervision of the Farm Credit Administration;<sup>21</sup> and
- residential, multifamily, and health care facility mortgage loan assets, or securitizations based on such assets, insured or guaranteed by the US or an agency thereof (excluding Fannie Mae, Freddie Mac and federal home loan banking agencies).<sup>22</sup>

## 7. What other modifications does the Act make to the regulation of the securitization process?

■ **Disclosure and Reporting Requirements.** The Act amends the Securities Act of 1933, as amended (the “Securities Act”), to direct the SEC to adopt regulations that would require issuers of asset-backed securities to include in registration statements for asset-backed securities certain information about the assets collateralizing such securities. The regulations to be adopted by the SEC will include standards for the format of data provided by issuers and will require issuers to disclose asset-level data, to the extent necessary for investors to independently perform due diligence, such as the nature and extent of the compensation of the broker or originator of the assets collateralizing the securities and the amount of risk retained by the originator and the securitizer of those assets.

The new disclosure requirements mandated by the Act overlap with the disclosure requirements proposed by the SEC in the Proposed SEC Securitization Rules. The Proposed SEC Securitization Rules would amend the disclosure requirements of Regulation AB to include detailed asset-level data for each asset in the collateral pool securing an asset-backed security and require the data to be presented in standardized formats. Private offerings of structured finance products would also be affected through proposed amendments to (1) Rule 144A, which would require, as a condition for resale, that underlying transaction agreements contain a covenant by the issuer to provide to the security holder or prospective purchaser of securities the information required in a registration statement and any ongoing information regarding the securities that would be required under the Exchange Act if the issuer were required to file reports thereunder and (2) Rule 506 of Regulation D which would grant the purchaser of securities the right to obtain from the issuer the information required in a public offering of the securities.

The disclosure requirements of the Act do not expressly apply to private offerings of asset-backed securities but such private offerings could be affected through the changes to Rule 506 of Regulation D and Rule 144A proposed by the SEC.

■ **Representations and Warranties in the Asset-Backed Securities Market.** The Act requires the SEC to prescribe new regulations on the use of representations and warranties in the asset-backed securities market. The new regulations will require each nationally recognized statistical rating organization to include in any report accompanying a credit rating of asset-backed securities a description of the representations, warranties and enforcement mechanisms available to investors in such securities and how they are different from those provided in other issuances of similar

securities.<sup>23</sup> In addition, the new regulations will require securitizers to disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by such securitizers, so that investors will be able to identify asset originators that clearly have deficiencies in their underwriting.<sup>24</sup>

- **Due Diligence Review in Asset-Backed Securities Offerings.** The Act requires the SEC to issue rules requiring issuers of registered asset-backed securities to review the assets collateralizing such securities and to disclose the nature of such review.<sup>25</sup>
- **Conflicts of Interests Relating to Asset Backed Securitizations.** Section 621 of the Act amends the Securities Act by adding a new provision aimed at addressing certain conflicts of interests relating to asset-backed securities transactions. The new provision, in very confusing language, prohibits an underwriter, placement agent, initial purchaser or sponsor (or any affiliate or subsidiary of such entity) of an asset-backed security (including synthetic asset-backed securities), during the year after the first closing of the sale of the asset-backed security, 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.”<sup>26</sup> Although the Act is unclear, we believe this provision is aimed at preventing conflicts of interest of the kind that have occurred in certain structured finance transactions when, simultaneously with the issuance of ABS, an arranger of the transaction structures a short position in those ABS. The Act requires the SEC to issue rules implementing this provision within 270 days of the Act’s enactment;<sup>27</sup> until they do, the impact of this provision on the activities of those regulated by it remains unclear. It should also be noted that unlike other rules to be promulgated under the Act, which do not become effective until after a delayed period following their adoption, the rules promulgated by the SEC to implement this provision will become effective immediately upon their adoption.<sup>28</sup>

## 8. What is the timing for enactment and effectiveness of the rules issued under the Act?

- Regulators are required to issue regulations implementing the risk retention requirement within 270 days of the Act’s enactment.<sup>29</sup> The effective date of such regulations for (i) securities backed by residential mortgages will be one year after final rules are published in the Federal Register and (ii) all other classes of asset-backed securities will be two years after final rules are published in the Federal Register.<sup>30</sup>
- Rules relating to representations and warranties<sup>31</sup> and due diligence analysis and disclosure in asset-backed securities offerings must be enacted within 180 days of enactment of the Act.<sup>32</sup>

## 9. What are our views on the impacts of the Act on the ABS market?

The Act provides a framework for regulating asset-backed securities, but it does not provide much firm guidance on the regulation of specific types of asset-backed securities. The most obvious result of the Act will be an immediate focus on the Regulators by originators, underwriters, investors and their various lobbying organizations as such groups weigh in on how the Act's provisions should apply to different classes of assets and institutions. As market participants know, the regulatory approach to implementation of the Act and the scope of the rules will be extremely important.

Congress put a heavy burden on the Regulators to move quickly—likely without a full appreciation of the task at hand. One of the problems with the Act will be the difficulty for the Regulators to adopt meaningful regulations for the wide variety of asset classes underlying securitizations and the different types of asset-backed securities issued within the time allotted by the Act.

In order to meet the Congressional timeline set forth in the Act, there is a risk that the Regulators may issue broad rules, which are likely to be inexact and over-encompassing. For example, a rule that prohibits the issuance of “asset-backed securities unless...” is much more far-reaching than a rule that states “any issuance of a mortgage-backed security shall comply with the following...” but the former example would comply with the statutorily prescribed mandate (and it is questionable whether a piece by piece asset approach could possibly satisfy the provisions of the Act in the time allotted). If the Regulators adopt a prohibitive approach to the broad classifications of asset classes, the result will be rules that do not fit the specific types of financial assets securitized and lead to confusion, uncertainty and difficulties in bringing many types of securitizations to market. Unfortunately, one certainty of the Act and the impending regulations is that they will bring a myriad of unintended consequences to the marketplace.

1. An “asset-backed security” is defined as a fixed-income or other security collateralized by any type of self-liquidating 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, including (i) a collateralized mortgage obligation; (ii) a collateralized debt obligation; (iii) a collateralized bond obligation; (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the SEC, by rule, determines to be an asset-backed security. A security issued by a finance subsidiary exclusively to entities controlled by the parent entity of the finance subsidiary is excluded from the definition of asset-backed security. Section 941(a) of the Act (to be codified at Section 3(a)(77) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”).
2. A “securitizer” is defined as (A) an issuer of an asset-backed security or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer. Section 941(b) of the Act (to be codified at Section 15G(a)(3) of the Exchange Act).
3. An “originator” is defined as a person who (A) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and (B) sells an asset directly or indirectly to a securitizer. Section 941(b) of the Act (to be codified at Section 15G(a)(4) of the Exchange Act).
4. Section 941(b) of the Act (to be codified at Section 15G(b)(1) of the Exchange Act).
5. Section 941(b) of the Act to be codified at Section 15G(c)(1)(G)(iv) of the Exchange Act).
6. The Act requires the Federal banking agencies, the SEC, the Secretary of Housing and Urban Development, and the Director of the Federal Housing Finance Agency to define “qualified residential mortgage” and to issue regulations to exempt asset-backed securities collateralized exclusively by qualified residential mortgages from the risk retention requirement. The regulations will specify, however, that an asset-backed security collateralized by other asset-backed securities (even if the underlying collateral for such asset-backed securities is qualified residential mortgages) will not be exempt from the risk retention requirement. Section 941(b) of the Act (to be codified at Section 15G(e)(4) and (5) of the Exchange Act).
7. Section 941(b) of the Act (to be codified at Section 15G(c)(1)(B)(ii) and 15G(c)(2)(B) of the Exchange Act).
8. Section 941(b) of the Act (to be codified at Section 15G(d)(2) of the Exchange Act).
9. In addition to the SEC and the Federal banking agencies, the Secretary of Housing and Urban Development and the Federal Housing Finance Agency will be involved in setting the regulations around credit risk for residential mortgages.
10. Section 941(b) of the Act (to be codified at Section 15G(c)(1)(E)(ii) of the Exchange Act).
11. See *Asset-Backed Securities*, Release No. 33-9117 (April 7, 2010) (referred to herein as the “Proposed SEC Securitization Rules”).
12. The definition of “sponsor” proposed in the Proposed SEC Securitization Rules tracks clause (B) of the definition of “securitizer” as set forth in footnote 2 above.
13. Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection With a Securitization or Participation After September 30, 2010, 75 Fed. Reg. 94, 27471 (May 17, 2010) (to be codified at 12 C.F.R. pt. 360).
14. *Id.* at 27480.
15. Section 941(b) of the Act (to be codified at Section 15G(c)(1)(A) of the Exchange Act).
16. Section 941(b) of the Act (to be codified at Section 15G(e)(1) of the Exchange Act).
17. Section 941(b) of the Act (to be codified at Section 15G(e)(1) of the Exchange Act).
18. Section 941(b) of the Act (to be codified at Section 15G(e)(2) of the Exchange Act).
19. Section 941(b) of the Act (to be codified at Section 15G(e)(4) and Section 15G(e)(5) of the Exchange Act). As a condition to this exemption, an issuer must certify, for each issuance of an asset-backed security collateralized exclusively by qualified residential mortgages, that the issuer has evaluated the effectiveness of internal controls for determining that all assets collateralizing such asset-backed security are qualified residential mortgages.
20. Section 941(b) of the Act (to be codified at Section 15G(c)(1)(G)(ii) of the Exchange Act).
21. Section 941(b) of the Act (to be codified at Section 15G(e)(3)(A) of the Exchange Act).

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22. Section 941(b) of the Act (to be codified at Section 15G(e)(3)(B) of the Exchange Act).
23. Section 943(2) of the Act.
24. Section 943(2) of the Act.
25. Section 945 of the Act (to be codified at Section 7(d) of the Securities Act).
26. Section 621(a) of the Act (to be codified as Section 27B(a) of the Securities Act).
27. Section 621(a) of the Act (to be codified as Section 27B(b) of the Securities Act).
28. Section 621(b) of the Act.
29. Section 941(b) of the Act (to be codified at Section 15G(b)(1) and (2) of the Exchange Act).
30. Section 941(b) of the Act (to be codified at Section 15G(i)(1) and (2) of the Exchange Act).
31. Section 943 of the Act.
32. Section 945 of the Act (to be codified at Section 7(d) of the Securities Act).

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