



## The Latest Proposals for Securitization Reform

On November 10, Senator Dodd released a discussion draft of the Restoring American Financial Stability Act of 2009 (the “Senate Proposal”).<sup>1</sup> On October 27, the House Financial Services Committee released a discussion draft of the Financial Stability and Improvement Act of 2009 (the “House Proposal”).<sup>2</sup> Subtitle D of Title IX of the Senate Proposal (the “Senate ABS Proposal”) and Subtitle F of the House Proposal (also referred to as the Credit Risk Retention Act of 2009) relate specifically to asset-backed securitization reform (the “House ABS Proposal,” and together with the Senate ABS Proposal, the “ABS Proposals”). The ABS Proposals would amend applicable banking regulations and federal securities laws to provide for issuer credit risk retention and more transparent credit risk reporting associated with asset-backed securities. Although the ABS Proposals are based on the proposed legislation submitted to Congress by the Obama Administration in July (the “Obama Proposal”), there are some important differences between the bills which are discussed in more detail below.

### Background

As a result of the financial crisis, the U.S. Congress, various U.S. government agencies, and the Obama Administration have been working to develop legislation that would strengthen market regulation to avoid a future crisis and restore investor confidence. The securitization market has received a lot of attention because of the role it played in financing sub-prime mortgage loans. On June 17, 2009, the U.S. Treasury Department released a report, “Financial Regulatory Reform - A New Foundation: Rebuilding Financial Supervision and Regulation” (the “Treasury Report”). Similar to the House and Senate Proposals, the Treasury Report addressed overall financial regulatory reform and the concept of “too big to fail” institutions. In the case of securitization, the Treasury Report focused on poor underwriting standards as the cause for the breakdown of the securitization market and recommended (1) altering incentive structures; (2) aligning compensation with long-term performance of assets; (3) increasing transparency of the securitization market; (4) strengthening performance of credit rating agencies; and (5) reducing over-reliance on credit ratings.

Neither of the ABS Proposals provides for alignment of market participant compensation with the performance of securitized assets. Nor do the proposals address the entire securitization-specific credit rating agency issues referenced in the Treasury Report.

### Credit Retention - Altering Incentive Structures

Under the House ABS Proposal, the applicable banking regulations and the federal securities laws would be amended to require creditors to retain an economic interest in a material portion of credit risk for any loan they originate and that is transferred, sold, or conveyed to a third party. In the event that a securitizer of asset-backed

<sup>1</sup> Available at [http://banking.senate.gov/public/files/AYO09D44\\_xml.pdf](http://banking.senate.gov/public/files/AYO09D44_xml.pdf) (last viewed on November 11, 2009).

<sup>2</sup> Available at [http://www.house.gov/apps/list/press/financialsvcs\\_dem/title\\_i\\_discussion\\_draft\\_final.pdf](http://www.house.gov/apps/list/press/financialsvcs_dem/title_i_discussion_draft_final.pdf) (last viewed on November 11, 2009).

securities chooses to securitize assets for which the creditor has not retained the required level of credit risk, the securitizer must retain an economic interest in a material portion of such credit risk.

This differs from the Senate ABS Proposal and the Obama Proposal, which require only securitizers to retain an economic interest in a material portion of credit risk for assets they securitize; although, under those proposals, the Agencies are permitted, but not required, to provide for the allocation of risk retention obligations between a securitizer and an originator in cases where a securitizer purchases assets from an originator.

The bills also differ as to how much risk must be retained by the creditor or securitizer. Under the House ABS Proposal and the Senate ABS Proposal, a minimum of 10% of the credit risk would be retained by creditors or securitizers (under the Senate ABS Proposal, only securitizers). Under the House ABS Proposal, the 10% credit risk retention could be adjusted if certain underwriting or due diligence standards set by the applicable federal banking agencies and the Securities Exchange Commission (the "SEC," and together with the federal banking agencies, the "Agencies") are met. In such cases, the creditor or securitizer would be required to retain as little as 5% of the credit risk. In cases where the Agencies determine that minimum underwriting or due diligence standards are not met, the minimum credit risk retained by the creditor or securitizer may be set above 10%. The Senate ABS Proposal does not give the Agencies the same type of authority to adjust the credit risk retention. Under the Obama Proposal, securitizers would be required to retain a minimum of 5% of the credit risk.

In addition to the minimum credit risk retention, all three proposals require the establishment of regulations (1) prohibiting a creditor or securitizer from directly or indirectly hedging or otherwise transferring the credit risk it is required to retain; (2) setting the minimum holding period for the risk retained; and (3) specifying the type of credit risk retained. With regard to (3), the House ABS Proposal requires regulations specifying that the credit risk retained must be no less at risk for loss than the average of the credit risk not so retained; whereas, the Senate ABS Proposal and the Obama Proposal only require regulations specifying the permissible forms of the risk retention that are required (*i.e.*, first loss position or *pro rata* vertical slice).

All these proposals grant the Agencies the authority to jointly exempt or adjust some or all of the above requirements if the exemption or adjustment is consistent with the purpose of ensuring high quality underwriting standards for creditors, facilitating appropriate risk management practices by such creditors, improving access for consumers to credit on reasonable terms, or otherwise serving the public interest. In addition, the Senate ABS Proposal and the Obama Proposal would grant exemptions for securitizations of assets issued or guaranteed by the United States, an agency of the United States, or a Government-sponsored enterprise.

By requiring market participants to keep "skin in the game" by retaining credit risk and rewarding those market participants that adhere to stringent underwriting standards and/or due diligence guidelines by reducing the amount of credit risk such participants have to retain, the House ABS Proposal provides incentives for good behavior and may reduce or eliminate the risky behavior that most believe led to the sub-prime mortgage market meltdown. The Senate ABS Proposal also encourages securitizers to commit to more stringent due diligence but not by rewarding good behavior with reduced credit risk retention; instead, the Senate ABS Proposal requires disclosure of due diligence analysis as discussed in more detail below.

### SEC Reporting and Registration - Increased Issuer and Credit Rating Agency Transparency

All three proposals also require amendments to the federal securities laws to increase disclosure obligations for issuers of asset-backed securities. Such disclosures would include asset-level or loan-level data regarding the assets backing the securities for each class or tranche of security issued. Such data would also include unique identifiers identifying loan brokers or originators, broker or originator compensation and the amount of risk retention of the originator or securitizer. In addition, the proposals require credit rating agencies to explain representations and warranties made with regard to asset-backed securities in any credit rating report, and require originators to disclose fulfilled repurchase requests across all securitizations. As mentioned above, the Senate ABS Proposal also includes an additional disclosure obligation for issuers. As an issuer of asset-backed

securities, the issuer would be required to perform a due diligence analysis of the assets underlying each issuance of securities and disclose the nature of the analysis in the issuer's SEC registration statement relating to the asset-backed securities.

## The Securitization Industry Responds

As legislators and government agencies continue to disagree over how to resolve non-securitization issues relating to systemic risk and "too big to fail" institutions, the securitization industry is discussing concerns over the recent ABS Proposals. Most notably, the American Securitization Forum (the "ASF") has submitted a mark-up of the House ABS Proposal to the House Financial Services Committee.<sup>3</sup> The ASF's major issues are the blanket requirements and restrictions that do not take into account the various types of asset-backed security products or structures, or the various types of economic risk involved in such products and structures. The ASF points out that those data disclosure requirements may be useless, or even unavailable, for certain asset classes and that other data may be more useful to investors investing in other asset classes. The ASF also takes the position that credit rating agencies should not be responsible for providing descriptive analyses of representations, warranties, and repurchase mechanisms; rather, this should be left to the issuer. Lastly, another area of concern is the impact the House ABS Proposal could have on the U.S.'s position in global financial markets. The proposed 10% credit risk retention requirement is much higher than the 5% risk retention requirement proposed in various foreign jurisdictions and would put U.S. industry participants at a competitive disadvantage and create market inconsistencies.

## Next Steps

Although all three proposals are similar and address the issues raised in the Treasury Report, it appears unlikely that Congress will enact legislation before the end of 2009. Legislators, government agencies, market participants and investors are still in disagreement over how to resolve other issues relating to systemic risk and "too big to fail" institutions. As securitization reform most likely will be part of broader financial reform legislation, industry participants will have some time before the implementation of new securitization rules. However, given the similarities among the Obama Proposal, the House ABS Proposal, and the Senate ABS Proposal, industry participants should be on notice as to what to expect in the near future.

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<sup>3</sup> A copy of the mark-up and a summary of ASF's positions are available at <http://www.americansecuritization.com/story.aspx?id=3741> (last viewed on November 11, 2009).