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News Bulletin

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Credit Risk Retention Rule Comment Period Extended

In late March, after considerable delay and reported behind-the-scenes interagency debate, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the Department of Housing and Urban Development, the Federal Housing Finance Agency, and the Office of the Comptroller of the Currency (the "Joint Regulators") issued a notice of proposed rulemaking (the "NPR") that included text of a draft rule on credit risk retention in securitizations proposed to be adopted by each Joint Regulator as required by section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The NPR solicited public comment on the proposed risk retention rule, and established a June 10, 2011 deadline for the submission of comments. On June 6, 2011, the Joint Regulators extended the comment deadline to August 1, 2011.

The Dodd-Frank Act requires that the section 941 credit risk retention rule be finalized by April 17, 2011 (a deadline already missed), and provides that the rule will become effective one year after publication of the final rule for residential mortgage-backed securities ("RMBS") and two years after such publication for all other types of asset-backed securities ("ABS"). When one considers that it will likely take the Joint Regulators several months following the comment deadline to adopt a final rule, it is evident that extension of the comment period has further pushed out the effective dates of the risk retention rules considerably beyond the April 2012 (for RMBS) and April 2013 (for other ABS) effective dates originally envisioned by Congress.

The NPR generally requires issuers of securitizations to retain 5% of the credit risk of each securitization unless an exemption is available. Since the issuance of the NPR, the Joint Regulators have been meeting with various industry participants and consumer advocacy groups to discuss concerns over the complexity of the NPR and its potential effects on the securitization market. According to the Joint Regulators, the extension was granted to allow commenters additional time to analyze the issues and provide their comments. For an overview of the NPR, see our news bulletin "U.S. Retained Credit Risk Rules Take Shape."

The NPR has caused concern among industry participants, consumer advocacy groups, and policy makers; and it has been the subject of Congressional hearings and letters from members of Congress to the Joint Regulators. The NPR's qualified residential mortgage ("QRM") exemption from the 5% risk retention requirement has received the most attention across constituent groups because of the perceived substantial economic and policy impacts of the QRM exemption on the housing market generally. With respect to RMBS, issuers are concerned about the premium cash reserve account requirement and the discrepancies between U.S. and European Union ("EU") risk retention rules. With respect to risk retention generally, industry participants are concerned about the rule's interaction with existing accounting and capital requirement standards, and the one-size-fits-all approach across asset classes that may make it difficult for issuers of other ABS to comply with certain provisions.

The purpose of this bulletin is to apprise the reader regarding the nature and state-of-play of the most significant issues raised by the NPR that likely contributed to the extension.

Concerns Over QRM Exemption: Too Narrow?

The NPR generally requires issuers of securitizations to retain 5% credit risk of each securitization unless an exemption or reduction is available. A recent Federal Reserve study reported to Congress urged the Joint Regulators to consider the interaction of credit risk retention requirements with accounting and regulatory capital treatment in light of the fact that such interaction could have "a significant effect on the cost and availability of credit" and highlights the concern that such interplay "may make securitization a less attractive form of financing and may result in lower credit availability."[1]

The concern raised in the report highlights the policy debate over the credit risk retention exemptions available for RMBS. Although the Obama Administration recently released a report on housing finance reform that advocates reducing the federal government's role in supporting the housing market, 97% of U.S.-issued RMBS were issued by the by Fannie Mae and Freddie Mac (the "GSEs") in 2010.[2] Despite a lack of private financing in the U.S. housing market, the NPR exempts RMBS issued or guaranteed by the federal government, including those issued by the GSEs, while only exempting RMBS issued by the private sector if all assets in the asset pool consist solely of QRMs. This disparity has attracted the attention of industry participants, consumer advocacy groups, and policy makers because less than 20% of the loans purchased or securitized by the GSEs from 1997 to 2009 would have qualified as QRMs.[3]

The QRM requirements that have been the focus of the most intense debate are the strict underwriting requirements that may not be varied in an underwriter's discretion: a 20% down payment requirement in the case of a purchase transaction; maximum front-end and back-end borrower debt-to-income ("DTI") ratios of 28% and 36%, respectively; and a maximum loan-to-value ("LTV") ratio of 80% in the case of a purchase transaction.

From the financial industry's standpoint, these requirements increase the issuer's cost of securitizations because they severely limit the number of mortgages that can be securitized by the private sector without the issuer having to retain credit risk. From a consumer's standpoint, some assert these requirements will increase the cost of obtaining a mortgage loan for all but the wealthiest consumers and may put home ownership out of reach for many first-time homebuyers and middle-class families.

Sheila Bair, the chairman of the FDIC, and other regulators have taken the position that QRMs are meant to be an exception to the "norm" and not the market standard in mortgage origination.[4] Those in favor of a narrow QRM exemption argue that the industry will adapt to risk retention and that the cost differential between QRMs and non-conforming mortgages for otherwise qualified borrowers will not be as dramatic as critics say. However, a bipartisan group of nearly 40 U.S. senators sent a letter to the Joint Regulators after the NPR was released stating that they intended to create a broad exemption for historically safe mortgage products when including the QRM exemption in the Dodd-Frank Act. In urging the Joint Regulators to broaden the scope of the QRM exemption, the senators wrote that "the extensive additional requirements for QRMs in the proposed rule swing the pendulum too far and reduce the availability of affordable mortgage capital for otherwise qualified consumers," and that "many borrowers would simply be forced to pay much higher rates and fees for safe loans that nevertheless did not meet the exceedingly narrow QRM criteria."

[1] The Board of Governors of the Federal Reserve System, Report to the Congress on Risk Retention, available at http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf (last viewed on June 8, 2011).
[2] [Tom Deutsche Testimony].
[3] [Tom Deutsche Testimony].
[4] See, for example, http://www.bloomberg.com/news/2011-03-28/lenders-said-to-get-exemption-option-under-risk-retention-rule.html (last viewed on June 8, 2011).

Both the House of Representatives Committee on Financial Services and a bipartisan group of 160 representatives also sent letters to the Joint Regulators stating that although the legislative intent of the QRM exemption was to "eliminate the culture of risk-free lending," the 20% down payment requirement inappropriately excludes too many otherwise qualified homebuyers from being able to obtain a QRM without any evidence that a 20% down payment results in sufficiently lower credit risk. In addition, the letter urges the regulators to consider including lower down-payment loans that have mortgage insurance rather than using a bright-line 20% rule. The letter also expresses concern over the proposal's "overly-narrow" debt to income restrictions.

Cost and availability of credit aside, industry participants also have voiced concern over different mortgage definitions proposed by regulators in response to the Dodd-Frank Act. Although DTI and LTV ratios were listed in the Dodd-Frank Act as possible factors to include when defining QRM, these ratios were not included in the definition of "qualified mortgage" under title XIV of the Dodd-Frank Act, which applies to both securitized and on-balance-sheet mortgage loans and exempts them from new ability to repay requirements. The Federal Reserve Board's proposal for "qualified mortgage" criteria leaves more underwriting discretion with the originator, whereas the QRM definition takes most underwriting discretion away. Industry participants hope regulators will align these two concepts.[5]

Other Concerns Raised

Although the QRM definition has been the subject of debate across constituency groups, comment letters filed to date and public discussions of the NPR reported in the press reveal that industry participants are concerned about a number of other provisions in the NPR that they feel may slow down recovery of the securitization market, including the premium capture cash reserve account requirement and differences between U.S. and EU risk retention regulations.

Premium Capture Cash Reserve Account and Excess Spread

Although the concept of a premium capture cash reserve account was not included in the Dodd-Frank Act, the NPR contains a largely unexpected provision that requires sponsors to adjust the required amount of risk retention held to account for any "excess spread" that is monetized at the closing of a securitization in order to prevent sponsors from effectively reducing the economic exposure they are required to retain. To achieve this adjustment, any sponsor who sells premium or interest-only tranches in securitizations must deposit any "excess spread" into a "premium capture cash reserve account." The amount in the premium capture cash reserve account would be used to cover losses on the underlying assets before such losses were allocated to any other interest or account.

Industry participants believe that there are a number of major flaws in this concept. In addition to concerns regarding conformance with Congressional intent, industry participants have identified a host of accounting and regulatory capital consequences that they believe will have a chilling effect on many otherwise beneficial securitizations and lead to unintended accounting and regulatory impacts. These issues appear to exemplify the concern that the Federal Reserve Board raised in its risk retention study to Congress in which it warned regulators to be mindful of the cumulative impact of new rules, especially with respect to accounting treatment and capital requirements.

[5] See, for example, http://www.americanbanker.com/issues/176_107/qrm-loans-new-normal-1038455-1.html?zkPrintable=1&nopagination=1 (last viewed on June 8, 2011).

Transatlantic Divergence

From a distance, the NPR appears similar to the risk retention rules in effect in the EU, which also contain a basic 5% risk retention requirement and a list of permissible retention methods, including vertical and horizontal retention, which appear parallel to the methods recognized under the NPR. Upon closer examination, however, the NPR differs considerably from the risk retention rules already applicable in the EU. The EU risk retention rules are embodied in Article 122a of EU Capital Requirements Directive 2009/111/EC ("CRD II"), as amended by the European Parliament and implemented through enabling legislation in EU Member States. In the EU the principal responsibility for monitoring compliance with risk retention rules is placed on investors that are "credit institutions" — essentially banks. Article 122a permits credit institutions to invest in securitizations only if one of the originator, securitization sponsor or original lender has complied with the risk retention requirement. The various methodologies that may be used to retain risk differ between the NPR and Article 122a and there are limited risk retention exemptions available under Article 122a, including no exemption similar to the QRM exemption. In addition, the NPR's controversial "premium capture rule" discussed above does not have a counterpart under Article 122a. Article 122a became effective for asset-backed securities issued on or after January 1, 2011.

In many respects, the proposed U.S. risk retention rule is more favorable to issuers than the EU rules, since the U.S. rule includes a number of exemptions, including the QRM exemption, not available in the EU. However, in the case of global offerings and other multi-jurisdiction transactions, the divergence between the effects of extraterritorial application of the NPR and Article 122a is particularly pronounced, and may place U.S. issuers at substantial disadvantage relative to EU issuers. This disadvantage is most pronounced with respect to offerings outside of Europe or the U.S. Because the NPR would apply to U.S. issuers anywhere in the world, a U.S. issuer limiting an offering to Asia or South America, for example, must comply with the U.S. risk retention rules, whereas a European issuer does not have to comply with EU requirements unless they are required by an EU investor. The disadvantage also pertains to European offerings, however. A U.S. issuer issuing into Europe must apparently comply with both the U.S. and the EU risk retention rules. Where there are differences, the U.S. issuer presumably must observe the more restrictive provisions. In contrast, an EU issuer issuing into the U.S. is only required to follow the U.S. rules, and an EU issuer issuing into Europe must only comply with the EU rules. For an overview of Transatlantic differences, see our news bulletin "Transatlantic Navigation of Securitization Reforms: A Guide."

Does One Size Fit All?

Industry participants are concerned that the approach taken under the NPR does not provide enough flexibility for certain asset classes, or reflect the reality of certain ABS markets. For example, sponsors of asset-backed commercial paper ("ABCP") argue that they already assume in excess of 5% of the risks of the assets financed in conduits through credit support facilities. Although the Joint Regulators provide an exemption from the risk retention requirements for certain ABCP conduits, a number of the requirements for meeting the exemption are inconsistent with established market practices. Furthermore, because many investors look to the credit quality of the sponsor and the credit facilities in place rather than rely on income generated from the assets, some participants argue that it is not clear if ABCP meets the definition of "asset-backed security" under the Dodd-Frank Act.

In other areas, certain risk retention methodologies and other requirements under the NPR appear to work better in some ABS markets than in others, but participants in virtually every non-RMBS asset class have identified respects in which the risk retention methodologies are not appropriate for their asset class. Industry participants from the auto sector, credit card sector, and student loan sector have voiced concerns over the inflexibility of various provisions and their effects on current market practices.

Relationship to Other Dodd-Frank Rulemakings

The extended comment period for the NPR is only one of more than two dozen of such extensions that regulators have granted during the Dodd-Frank Act implementation process. In recent weeks the extent of rulemaking delays has become the subject of increasing comments and debate in the press and in political circles. Some argue the delays are necessary due to the complexity of the proposed rules, the need to understand how they relate to one another, the time required to implement any changes, and the impact such changes will have on the financial markets. Others view the delays as attempts by various parties to kill new regulation through political wrangling and exhaustion of regulatory agency resources.

In the case of the NPR, however, there can be little doubt that the issues addressed are complex, and that the consequences of unwise choices are potentially critical to the recovery of the U.S. economy and housing market considering the substantial and essential role securitization has historically played in the financing of U.S. real estate and consumer assets. It is to be hoped that the extension of the NPR comment period will lead to a more sound regulatory framework for U.S. securitization going forward.

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