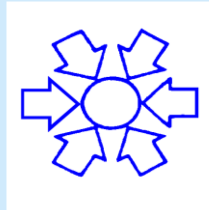

Financial Services Management

Asset-Backed Securities Regulation

Capital Markets	Government Relations Action Item

Cite

Dodd Discussion Draft
Title IX
Subtitle D—Improvements to the Asset-Backed Securitization Process

Recommended Distribution

Capital Markets, Asset/Liability Management, Legal, Government Relations

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http://banking.senate.gov/public/_files/AYO09D44_xml.pdf

Overview

In Title IX of his discussion draft, Senate Banking Committee Chairman Dodd (CT) takes a different approach to governing asset-backed securitization (ABS) than the Obama Administration[1] or the House Financial Services bill, as reported.[2] The Dodd bill includes a tough, ten-percent retention requirement for ABS, but applies this only to securitizers, not also to originators as in the other proposals. The legislation also provides a broader framework for potential exemptions from the risk-retention requirement, although it tracks the other legislation with additional tough disclosure and liability requirements for ABS issuers and originators. Mortgage-backed securities (MBS) originators would come under tough new securities-law exposure as "underwriters."

[1] See Client Report **ABS4**, *Financial Services Management*, August 19, 2009.

[2] See Client Report **SYSTEMIC19**, November 18, 2009.

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Impact

Sen. Dodd's proposal builds on the growing view among policy-makers that incentive and transparency problems in the ABS market were a significant spark to recent systemic risk. The Administration included ABS reform in its sweeping package based on the view that misplaced incentives helped to create the financial-market crisis. These result, it said, from the "originate-to-distribute" model in which originators and securitizers could package mortgages and other loans into ABS without any risk at any point to themselves, leading investors – often lulled by favorable ratings – to purchase billions of dollars in ABS or complex collateralized debt obligations and similar instruments constructed from them. Global regulators have placed the originate-to-distribute issue as a top priority, with the Basel Committee recently releasing new guidance designed to ensure that banks participating in complex ABS activities hold capital regardless of their nominal risk in these arrangements.[3] However, the Obama Administration approach, and now the Dodd bill, go considerably beyond the Basel guidance, largely reflecting an approach in the European Union that – regardless of bank capital standards – requires all securitizers to hold significant amounts of capital at risk. And, as noted, the Dodd bill is even tougher – it mandates a ten percent minimum requirement, not the five-percent one included in the Administration legislation.

While advocates believe that risk-retention requirements will instill market discipline, originators and securitizers counter that they could simply not engage in this activity if forced to hold long-term capital against risks removed from their balance sheets even under new, rigorous accounting rules. This is particularly problematic for mortgage brokers – who generally have small financial resources – but it is also a serious concern for even large, capitalized originators. The additional risk-retention requirement expressly related to ABS would be so punitive, they say, that loans would simply not be securitized. Reflecting these concerns, the Dodd bill would apply only to securitizers, although regulators could permit them to share the risk-retention requirement with originators, which many fear would be done because of the power large securitizers can exert. This would, opponents argue, choke off liquidity to a wide array of asset classes – consumer finance first among them – in which securitization has become critical. In pursuit of several new facilities to support securitization,[4] Treasury argued that securitization accounted for forty percent of consumer finance before the crisis and must be encouraged if markets are to recover.

In addition, the legislation would impose an array of new restrictions designed to ensure that investors fully understand the risks involved in ABS

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[3] See Client Report **CAPITAL151**, *Financial Services Management*, July 23, 2009.

[4] See Client Report **TALF**, March 3, 2009, and Client Reports **PPIP3**, *Financial Services Management*, March 31, 2009 and **PPIP4**, *Financial Services Management*, April 21, 2009.

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instead of relying solely on credit rating agencies (CRAs). New supplemental disclosures would apply for all but SEC-registered ABS to provide an array of loan-level detail, with new standards also requiring the CRAs to disclose the backing issuers provide on ABS and the degree to which they subsequently meet any such commitment. All of these data requirements will likely be burdensome and could subject brokers and other originators to considerably more transparency. However, they are intended to ensure investor credit-risk analysis independent of simple ratings designations.

As noted, the legislation could subject MBS originators to treatment under the securities law as underwriters. The exemption in current law was designed to ensure that mortgage securitization from brokers, small lenders and other entities could proceed in an efficient fashion, based on the view that these originators lacked the capital and operational capacity to absorb the three years of legal risk imposed on underwriters. With this additional risk, even transactions that would otherwise be “true sales” under FASB rules might now be subject to accounting consolidation, and, as a result, regulatory-capital requirements. With this new liability, many originators might eschew mortgage securitization and, if possible, hold loans in portfolio. This would address the originate-to-distribute issues, but again raise the specter of reduced credit availability in a sector critical to market recovery. To the degree that small originators abandon the mortgage market, concentration in that sector – already significant in the wake of the crisis – would increase.

What’s Next

Sen. Dodd released this draft on November 10. His panel held an initial mark-up on the draft on November 19, when significant opposition to much in the overall package was evident. However, the ABS provisions did not garner attention and will likely proceed to mark-up. As noted, the Dodd bill as introduced is very different from the FinServ-approved measure, on which floor action is expected on December 9.

Even as Congress considers ABS issues, bank regulators are advancing numerous proposals with direct impact on the risk-retention requirements. These include a pending inter-agency proposal addressing the capital consequences of new FASB rules that require consolidation for any risks related to ABS.[5] In addition, the FDIC has issued a temporary safe harbor to insulate ABS assets held by insured depositories from the FDIC’s rights in a receivership,[6] but more sweeping final rules are in the works.

[5] See Client Report **ABS4**, *Financial Services Management*, August 19, 2009.

[6] See Client Report **ABS6**, *Financial Services Management*, November 19, 2009.

Federal Financial Analytics, Inc.
1121 Fourteenth Street, N.W., Washington, D.C. 20005
Phone: (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com Web Site: www.fedfin.com

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Analysis

A. Credit-Risk Retention

1. Regulatory Framework

The FRB, FIRA, FDIC and SEC would, no later than 270 days after enactment, need to issue rules implementing this requirement. Securitizers would need to retain an economic interest in a material portion of the credit risk for ABS. The rules would need to:

- bar direct or indirect credit-risk hedging of the risk-retention requirement;
- require retention of at least ten percent of credit risk;
- specify the permissible forms of risk retention and its minimum duration; and
- apply regardless of whether the securitizer is an insured depository.

The rules could, however, provide for:

- a total or partial exemption for U.S. Government, agency or GSE ABS;
- a total or partial exemption for other ABS found to be in the public interest or for the protection of investors; or
- the allocation of risk-retention responsibility between a securitizer and originators.

In addition, the banking agencies (but apparently not the SEC) could exempt or adjust any class of institutions or assets from the risk-retention requirement or the hedging ban. Any such provisions would need to:

- ensure high-quality underwriting;
- encourage appropriate risk management;
- improve consumer credit access; or
- otherwise be in the public interest and for investor protection.

2. Enforcement

FIRA would govern insured depositories and the SEC would enforce the rules for everyone else.

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B. Reporting and Disclosures

The SEC would gain expanded authority to demand periodic reports on ABS, doing so by class of issuer if desired. However, the SEC would need to mandate new disclosures for all ABS issuers to provide in-depth information on assets underlying ABS to permit investors to perform their own due diligence (e.g., individual loan identifiers, information on originator compensation, risk-retention amounts). The disclosures would also need to provide information to permit comparison across asset classes.

Further, 180 days after enactment, the SEC would need to issue rules governing ABS registration that require issuers to perform due diligence on underlying assets and disclose their analysis.

C. Representations and Warrantees

No later than 180 days after enactment, the SEC would need to issue rules on ABS reps and warrants (as these risk-transfer agreements are usually known). Each credit rating agency would need to include information on them and related enforcement rights in any rating, showing how these instruments in the rated ABS may differ from conventional practice in the asset class. In addition, the SEC would need to require originators to disclose fulfilled repurchase requests.

D. Securities Law Coverage

The bill would end the exemption from the Securities Act for all originators of mortgages sold to third parties. These originators would be considered underwriters, resulting in three years of legal liability.

Federal Financial Analytics, Inc.
1121 Fourteenth Street, N.W., Washington, D.C. 20005
Phone: (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com Web Site: www.fedfin.com

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