Hunton & Williams

Client Alert

Financial Industry Recovery Center

June 2009

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President Obama's Regulatory Reform Proposal: No Surprises for the Securitization Industry

The Obama Administration's proposed regulatory reform has been called by the *Wall Street Journal* "the most sweeping overhaul of the way the U.S. government oversees financial markets since the 1930s." Controversy surrounds a number of elements of the broad proposal, a copy of which may be found here, notably the proposal's plan to increase the Federal Reserve Board's role in regulating any large financial institution whose combination of size, leverage and interconnectedness to other financial institutions could pose a threat to financial stability if it failed. This supervision would extend to foreign parents and subsidiaries regardless of whether those entities are currently subject to regulation by authorities in the United States. Another controversial provision of the proposal is the creation of the Consumer Financial Protection Agency, whose mission includes encouraging the offering of "plain vanilla" products and banning or restricting "yield spread premiums," prepayment penalties and other practices thought to be unfair to unsophisticated consumers. For the most part, however, the elements of the proposal that touch on the securitization market incorporate concepts already being discussed among market participants, which suggests that the securitization market is moving in the right direction with those policies it proactively has taken under review.

The Administration, for example, charges the Securities and Exchange Commission (the "SEC") to issue new regulations to improve and standardize disclosure practices related to securitization, and to require the disclosure of loan-level information and reporting of material information for the life of a securitization transaction. The SEC is working on these kinds of improvements already, with the strong support of the American Securitization Forum. The Administration also encourages the industry to standardize legal documents for securitization transactions, including provisions more clearly permitting mortgage modifications where they would benefit the securitization trust as a whole. The industry is already moving toward standardization in these areas, led by the American Securitization Forum's "Project RESTART."

The Administration's proposal includes several elements designed to ensure that participants in securitizations have incentives to consider how the underlying assets perform during the life of the securitization. Many commentators have suggested that, to date, originators had little incentive to use strict underwriting criteria for origination of mortgage loans or other financial assets and that those parties involved in securitization transactions have had little incentive to conduct extensive due diligence on the assets because both the originators and the sponsors of the securitizations transferred all the risks associated with the mortgage loans to investors at the closing of the securitization transaction. The solution, some have suggested, is to require the originator to retain some risk associated with the mortgage loans. The Administration's proposal encourages federal banking agencies to promulgate regulations requiring originators or sponsors to retain 5 percent of the credit risk without hedging that retained risk. Although most earlier proposals have focused on the originators retaining this risk, the Administration suggests that the requirements could be applied to sponsors as well as originators "in order to achieve the appropriate alignment of incentives contemplated by [the] proposal." Some in the industry have noted that losses have occurred in securitizations in which originators or sponsors have retained risk, as well as transactions in which all credit risk was transferred to parties other than the originator or securitization sponsor, and those critics have questioned the wisdom of imposing a risk retention requirement on all securitizations. These critics have urged, at a minimum, that such requirements should not be imposed without flexibility. The Administration proposes allowing the federal banking agencies to specify what form the risk retention should take (such as a first loss position or *pro rata* position) and to change the percentage of retention as well as to exempt entities, on a case-by-case basis, from the prohibition on hedging the risk.

The Administration also proposes that compensation of brokers, originators, sponsors, underwriters and others involved in securitization be "linked to longer-term performance of the securitized assets, rather than only the production, creation or inception of those products." For example, the proposal suggests that fees and commissions earned by loan brokers and officers should be paid over time, but be reduced if "underwriting or asset quality problems emerge." Similarly, the proposal suggests that most originators should not recognize gain at the inception of a securitization, but should recognize the gain over time, meanwhile keeping the assets on the books of the originator. A great deal of thought needs to be given to potential unintended consequences of these proposals, such as whether these arrangements constitute so much recourse that the assets in the securitization would be available to the creditors of transferors into the securitization. Moreover, the accounting implications of these proposals is unclear, particularly in light of the recent changes to accounting rules applicable to securitizations.

The Administration also proposes that securitization issuers be required to disclose the nature and extent of broker, originator and sponsor compensation, as well as the risk retention, for each securitization. These are elements that are not currently disclosed to investors in securitizations.

Not surprisingly, the Administration's proposal includes recommendations for reform of credit rating agencies. Most of these recommendations are not controversial: in fact, many, including the SEC, have proposed that credit rating agencies should be required to manage and disclose conflicts of interest more robustly and should disclose enough information about the methodologies for rating structured finance so that investors can reverse engineer conclusions reached by the rating agencies. The Administration also criticizes the rating system for structured products itself, proposing that a different rating system should be used for structured finance than is used for unstructured debt. Some in the securitization industry suggest that an alternative system would merely confuse investors. Most agree, however, with another suggestion made by the Administration: that the credit rating agencies publicly disclose precisely what risks their credit ratings are designed to assess, as well as material risks not reflected by the ratings. The Administration also suggests that regulators reduce their use of credit ratings in regulations and supervisory practices, where possible, and minimize opportunities for regulated entities to use securitization to reduce regulatory capital requirements where there is no reduction in actual risk to the regulated entities.

Furthermore, the Administration proposes creating the 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. Financial products subject to regulation by the SEC or Commodity Futures Trading Commission ("CFTC") would be outside the CFPA's jurisdiction. The CFPA would have supervisory authority to examine compliance by regulated institutions, including not only banks, but also many companies not previously subject to comprehensive federal supervision. 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. The CFPA's rules would not, however, preempt any state laws designed to protect consumers; instead, states would have the option to adopt stricter or different rules than those provided by the CFPA. Also, the states would have the right to enforce not only their own consumer protection laws, but also the federal laws promulgated by the CFPA.

The proposal stopped short of recommending that the SEC and the CFTC be merged into a single regulator: instead, it called for legislative changes that would harmonize regulation of futures and securities. Risk management seems to be an underlying theme of the derivatives proposals, including preventing undue concentrations of unhedged risk, such as the concentrations that occurred in the case of AIG and monoline insurance companies, and better management of counterparty credit risk. Counterparty regulation will include not only capital requirements, but also business conduct standards and other prudential regulation. Importantly and not surprisingly, the proposal suggests amending the commodities and securities laws so that standard OTC derivates are cleared through regulated central counterparties, so that the CFTC and SEC can impose recordkeeping and reporting obligations on OTC derivatives and so that dealers whose activities create large exposures to counterparties can be supervised and regulated, including being required to follow conservative capital requirements. The purpose of these requirements is to promote transparency in a market that has been opaque. Other changes will be sought to prevent market manipulation, fraud and other market abuses, to prevent marketing derivatives to unsophisticated parties and to promote market efficiency and price transparency. Position limits will be an option for achieving some of the proposal's objectives. Regulation of payment, clearing, settlement and other systemically important systems in the derivatives arena also will be forthcoming, the Administration notes.

Conclusion

The press leading up to the announcement of the Administration's proposal suggested that the proposal would be groundbreaking and unprecedented. The elements of the proposal relating to securitization, however, brought few surprises. It remains to be seen which elements of the proposal will survive the political struggle that surely will ensue, but it is clear that many of the elements related to securitization will be adopted, hopefully in keeping with current industry positions on the elements.

Hunton & Williams LLP is regularly listed among the nation's leading securitization law firms, including Thomson Reuters's 2009 first quarter capital markets rankings. The firm was ranked as a leader in 26 categories, including seven number one rankings and 13 top five rankings.

For more information about the administration's proposal and other financial developments, please feel free to call us or visit the Financial Industry Recovery Center at www.huntonfinancialindustryrecovery.com.

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