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“Originate-to-Distribute” Lives on in Securitizations of Plain Vanilla Residential Mortgages: The Securitization Reform Provisions of the Dodd-Frank Act

Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act” or the “Act”) constitutes the most sweeping financial reform package since the 1930s. Title IX of the Dodd-Frank Act (“Title IX”), entitled the “Investor Protection and Securities Reform Act of 2010” enacts a grab bag of substantial changes to capital markets regulation and practices in the hope of putting back in their bottles the twin genres of moral hazard and lax regulation that are widely viewed as the tinder that sparked the great credit conflagration of 2008. Subtitle D of Title IX, entitled “Improvements to the Asset-Backed Securitization Process” (“Subtitle D”), has been of particular interest to capital markets participants both because practices in securitization markets are widely credited with contributing uniquely to the credit crisis and because of the sense of many that the resuscitation of robust securitization markets is one of the key predicates to an economic recovery.

The reforms to the asset-backed securitization process contained in Subtitle D and elsewhere in Title IX are essentially intended to remove incentives embedded in the “originate-to-distribute” model that has been discredited during the financial crisis. The most significant change is the introduction of a requirement that sponsors of nearly all securitizations and/or originators of loans sold into securitizations retain a portion of the credit risk inherent in the pool of assets securitized. However, these risk retention requirements will not apply to securitizations of assets issued or guaranteed by the United States, any state, or any agency of the foregoing, or securitizations consisting solely of qualified residential mortgage loans that conform to parameters established by regulation. The result may be the continued viability of originate-to-distribute with respect to plain vanilla residential mortgages – that is, residential mortgages insured, guaranteed or designed by the government. Residential lenders that do not wish to retain risk or do not have capital to do so may be left with an originate-to-distribute business consisting of plain vanilla mortgages. This ultimately may limit consumer choice, restrict the availability of consumer credit and stifle innovation in the residential mortgage market.

Subtitle D is not the end of the game on securitization reform because it grants broad authority to regulators, who will determine the final score based on guidelines contained in Title IX of the [Dodd-Frank Act](#). The Securities and Exchange Commission (the “SEC”) has already issued its blueprint for many of the regulations required in its proposed amendment of Regulation ABⁱ (the “Regulation AB Proposal”) and the Federal Deposit Insurance Corporation (the “FDIC”) has also weighed in with its thoughts on reform of the rules governing securitizations by depository institutions in a rulemaking exercise (the “FDIC Proposal”).ⁱⁱ

This Alert will discuss principal themes of reform embedded in Title IX, with special reference to Subtitle D. These themes are risk retention, new disclosure and reporting requirements, regulation of the use of representations and warranties and regulation of conflicts of interest. It will then discuss the timing and process for regulatory implementation. Other K&L Gates client alerts address other aspects of financial reform in the Dodd-Frank Act. Additional information is available on the K&L Gates web site specially dedicated to [Financial Services Reform](#).

Substantive Provisions

Applicability

Subtitle D applies to all “asset-backed securities” other than securities issued in a securitization in which the only investors are affiliates of the sponsor of the securitization. The Dodd-Frank Act amends the Securities Exchange Act of 1934 (the “Exchange Act”) to define the term “asset-backed security” to include many categories of securitizations and structured products that were not previously subject to registration. The definition will now include collateralized mortgage obligations, collateralized debt obligations, collateralized bond obligations, and any other securities that the SEC determines are asset-backed securities – but will exclude any securities issued to affiliates by a finance subsidiary that issues securities only to its affiliates.

Risk Retention

General

Subtitle D mandates a rulemaking process (described below) to require that “securitizers” retain at least a five percent economic interest in a portion of the credit risk in each asset held in a securitization, subject to certain exclusions and exceptions discussed below. The term “securitizer” is defined to mean the issuer of asset-backed securities or the sponsor of a securitization. In apparent conflict with this mandate is a requirement that retained risk be allocated between securitizers and originators that deliver into securitizations for particular categories of assets, as determined with reference to the credit risk of the assets, the characteristics of securitization transactions involving those assets (e.g., form and volume), and the potential impact of a risk retention requirement on the availability of credit to consumers and

businesses. Subtitle D generally prohibits securitizers and originators from hedging any retained risk directly or indirectly, subject to exemptions promulgated by the SEC and the Board of Governors of the Federal Reserve System (the “FRB”), the FDIC and the Office of the Comptroller of the Currency (the “OCC,” and, together with the FRB and OCC, the “Bank Regulators”)ⁱⁱⁱ, and with respect to exemptions for residential mortgage securitizations, the U.S. Department of Housing and Urban Development (“HUD”) and the Federal Housing Finance Agency (“FHFA”).

The mandate of risk retention represents not only a sense that the financial crisis resulted in material part from an “originate-to-distribute” business model for residential mortgages, but also an expectation that requiring securitizers and originators to retain “skin in the game” (providing an incentive for them to monitor underwriting standards and obligor credit quality) will help rein in the excesses of that model. A risk retention requirement may be too blunt an instrument to be fully effective, particularly in light of the increased costs it implies that likely would be passed on to borrowers, assuming loans subject to the risk retention requirements would be made at all. The Act adopts a compromise position. It focuses risk retention on higher risk and unconventional products, while at the same time creating incentives for lenders, in the form of exemptions from, or reductions in, risk retention requirements, to originate and distribute loans that fit parameters established by Congress and the regulators.

Exclusion of Qualified Residential Mortgages from Risk Retention Requirements

Subtitle D excludes single-tranche securitizations of pools consisting solely of qualified residential mortgages from risk-retention requirements. By doing so, it creates a class of mortgage products – likely plain vanilla products – for which no risk retention is required and for which an originate-to-distribute business model will likely remain viable. These mortgage products would effectively be designed by the SEC, the Bank Regulators, HUD and FHFA when they jointly define the term “qualified residential mortgage,” subject only to general guidance from Congress. This guidance establishes minimal base line requirements relating

to the breadth of the definition as well as features relevant to default rates.

The definition of “qualified residential mortgage” may be no broader than the definition of “qualified mortgage” inserted into the Truth in Lending Act by the Dodd-Frank Act.^{iv} Under that definition, a qualified mortgage must satisfy all of the following criteria:

- No negative amortization and limited deferrals of principal payments;
- Limitations on balloon payments;
- Verified and documented financial resources of the borrower;
- Underwriting takes into account level amortization and payments of required taxes and insurance;
- Underwriting, with respect to adjustable rate mortgage loans, takes into account borrower’s ability to pay highest allowed rate during first five years;
- Complies with guidelines or regulations established by the FRB (or the Bureau of Consumer Financial Protection) related to debt to income;
- Points and fees of less than three percent of the total loan amount; and
- Term of thirty years or less.

In addition, Subtitle D provides that the definition of qualified residential mortgages in applicable regulations must take into account “underwriting and product features that historical loan performance data indicate result in a lower risk of default” and also requires regulators to restrict or prohibit in qualified residential mortgages any feature “demonstrated to exhibit a higher risk of borrower default.” Examples of relevant features include some of the features contained in the above definition, such as balloon payments and negative amortization. They also require the regulators to look at a broader range of underwriting practices or loan features based on historical experience with default rates, such as, among other things, documentation and verification of the obligor’s

assets and income, maximum debt-to-income ratios, features that may mitigate the potential for payment shock on adjustable rate mortgage loans, and the presence of mortgage guarantee insurance or other credit enhancements. These requirements assume an availability of uniform historical data from which the regulators could assess the risk of default associated with specific underwriting and product features and thus likely preclude a newly designed product from qualifying.

Subtitle D would require an issuer of asset-backed securities collateralized exclusively by qualified residential mortgages to certify that it has evaluated the effectiveness of its internal controls for ensuring that the pool consists solely of qualified residential mortgages. The Act would delegate enforcement of the regulations to both Bank Regulators (for securitizers that are insured depository institutions) and the SEC (for other securitizers).

The exemption from risk retention for qualified residential mortgages is necessary as originators may be reluctant to retain risk in mortgages they originate for a variety of reasons unrelated to the quality of the asset or soundness of underwriting. These may include capital constraints, questions about the accounting treatment of loan sales with retained risk, an institution’s policy for managing interest rate risk and liquidity concerns. The exemption for qualified residential mortgages serves to push mortgage lenders with such concerns towards qualified residential mortgages for distribution in securitizations. Unfavorable treatment in securitizations of certain products may make it difficult for all but the largest institutions to fund loans that contain provisions allowing for greater borrower flexibility. An institution would need sufficient size to appropriately manage the risks retained for these products, regardless of underwriting standards. New products or features, for which historical information on the risk of default is not available, likely will be subject to higher risk retention requirements versus conventional products. In sum, the push towards increased standardization of residential mortgages may come at the price of innovation.

Exclusion of Agency Guaranteed Loans from Risk Retention Requirements

Subtitle D of the Dodd-Frank Act contemplates additional exemptions from the risk retention requirements with respect to loans insured or guaranteed by government agencies or at the discretion of the regulators. It provides exemptions for securitizations of assets issued or guaranteed by the United States, any state, or any agency of the foregoing, as determined by the SEC and Bank Regulators. It also contains language excluding from its scope: (1) assets made, insured, guaranteed or purchased by an institution, that is subject to the supervision of the Farm Credit Administration, or (2) residential, multifamily, or health care facility mortgage loan assets, or securitizations based upon such assets, which are insured or guaranteed by the United States or any agency thereof. Exemptions for government insured loans – such as FHA-insured or VA-guaranteed loans that are included in Ginnie Mae securities – make sense, as it would be unclear how one could retain risk on an insured asset. For purposes of these exemptions, neither Fannie Mae nor Freddie Mac is considered an agency of the United States, although conforming loans separately may be exempt as qualified residential mortgages.

Other Exemptions

The SEC and the Bank Regulators, acting jointly, will have broad authority to grant any other exemptions for classes of institutions or assets from the risk retention requirements or the prohibitions on hedging retained risk, so long as those exemptions help ensure high underwriting standards and encourage appropriate risk management practices by securitizers and originators. This authority may be very useful to the SEC and Bank Regulators, as future market developments may vitiate the justifications for risk retention. However, neither the Regulation AB Proposal nor the FDIC Proposal contemplates any exceptions to the risk retention rules.

Form and Extent of Risk Retention

For securitizations in which risk retention is required, regulations must specify permissible forms of risk retention and the minimum duration of that risk retention. This could range from maintaining an interest in specific assets or in securities of the issuer of the asset-backed securities. Subtitle D itself does

not specify whether the retained risk must be first loss position, or a portion of each tranche of securities issued in the securitization. By comparison, the Regulation AB Proposal specified a portion of each tranche or “vertical slice” of the securitization.

The duration of risk retention could present some complexity, because neither the Regulation AB Proposal nor the FDIC Proposal specifies a period of time during which risk must be retained. The intent of the legislation appears to be to encourage more disciplined underwriting and pooling of securitized assets. Thus, the duration of any required risk retention should be related to a period during which defaults would be a function of underwriting, as opposed to other risks, such as interest rate risk, that materialize over the life of an asset.

Subtitle D charges regulators with allocating risk retention among securitizers and originators that deliver into securitizations. More specifically, it directs regulators to reduce the percentage of risk retention obligations required of the securitizer by the percentage required of the originator, and to promulgate rules considering factors such as: (1) whether the assets have low credit risk characteristics, (2) whether the form and volume of transactions in the marketplace create incentives for poor underwriting, and (3) how risk retention may impact the availability of credit. In many cases, these considerations would weigh in favor of allocating more risk to securitizers and less to originators. Originators in many lending businesses have historically not been capital intensive. Unless these originators are able to raise significant additional capital, pushing risk retention requirements to such originators would almost certainly have a negative impact on the availability of credit.

Thankfully, unlike the corresponding provision in the bill that was originally passed by the House of Representatives, the risk retention provisions do not apply to originators that merely sell loans in transactions not involving securitizations. Thus, there is no statutory risk retention for originators that sell loans to other institutions to be held in portfolio. However, regulations may be needed to address circumstances in which loans are sold

without the originator knowing or intending that such loans are to be securitized.

With respect to commercial mortgages, the Dodd-Frank Act authorizes regulators to allow a securitizer of commercial mortgage loans to transfer the first loss position retained risk subject to certain conditions. More specifically, regulations promulgated under the Act would require any transferee of the first loss position in a commercial mortgage securitization to: (1) hold adequate financial resources; (2) provide due diligence on all individual assets in the pool prior to securitization; and (3) meet the same standards for risk retention as the securitizer. Additional requirements on commercial mortgage securitizations would include a determination by the SEC and the Bank Regulators that the “underwriting standards and controls for the asset are adequate,” and specifications for representations, warranties, and remedies for breach thereof.

Changes to Disclosure and Periodic Reporting Rules

The Act’s securitization provisions also require more granular and extensive disclosures than are required under existing rules. For instance, the Act creates an obligation to disclose the nature of the due diligence review of underlying assets and enhance disclosure of contingent repurchase obligations through representations and warranties or otherwise. The Act also requires the SEC to adopt regulations setting forth the standards for disclosure in all issuances of asset-backed securities. The regulations would have to prescribe a standardized format for disclosures and require asset-level or loan-level disclosures. The asset- and loan-level disclosures would allow investors to perform independent due diligence by tracking brokers or originators of loans, determining the nature and extent of their compensation, and identifying the amount of risk each has retained in the securitized assets. The SEC has already commenced revising the disclosures required in a registered offering through its Regulation AB Proposal.

Of particular significance to sponsors, the Act eliminates for asset-backed securities the ability of issuers or depositors to suspend reporting obligations under the Exchange Act, when the number of investors in a securitization falls below a

specified threshold, typically three hundred persons. This may not materially affect the amount of information required to be provided in connection with asset-backed security transactions where the information reporting requirements of the transaction documents generally mirror what is required of issuers of publicly held asset-backed securities. However, the loss of suspension of reporting increases the risk that asset-backed security sponsors may lose eligibility to use shelf registration statements for certain asset-backed securities owing to non-compliance with the reporting obligations imposed by the Exchange Act. This change in the law may encourage the continuation of private placements of asset-backed securities, notwithstanding required compliance with the same risk retention and disclosure obligations governing securities issued in public offerings.

The Act also eliminates the exemption from registration for mortgage-related securities that had been included in the Securities Act of 1933 by the Secondary Mortgage Market Enhancement Act. This change will likely effect a substantial reduction in unregistered offerings of asset-backed securities backed by mortgage-related assets.

Representations and Warranties

Subtitle D also would require the SEC to prescribe regulations on the use of representations and warranties in the securitization markets. The regulations would require each credit rating agency to include in its rating report a description of representations, warranties, and remedies in a securitization, along with a comparison with other securitization transactions. The regulations also would require securitizers to disclose the level of repurchase requests made, both fulfilled and unfulfilled, across all securitizations sponsored by such securitizer.

Conflicts of Interest

The Act also prohibits an underwriter, placement agent, initial purchaser, or sponsor with respect to any asset-backed security, or any of their respective affiliates, from engaging in any transaction that presents a conflict of interest with investors in the asset-backed securities for a period of one year from and after the first closing of the offering of such

securities. Exceptions exist for risk-mitigating hedging activities, commitments to provide liquidity, and bona fide market making activities. As with most other provisions of the Act, regulations will be required to give color to the general rule and exceptions. In this case, the regulations are to be promulgated by the SEC.

Required Rulemaking

The Dodd-Frank Act takes an indirect approach to securitization reform by delegating many decisions to regulators and authorizing them to create exemptions and otherwise limit the effect of many provisions of the Act to specified issuer types and asset classes. This approach could result in a more nuanced treatment of many difficult issues than Congress could have created through legislation. Coordinated rulemaking also mitigates the possibility of having different requirements depending upon the nature of the entity sponsoring a securitization or originating receivables. It also means that the full effect of the legislative provisions will not be felt for quite a long time.

Subtitle D requires that the applicable regulators issue implementing regulations within 270 days after enactment of the Dodd-Frank Act. Those regulators are the SEC, the Bank Regulators, HUD and the FHFA. The regulations will have to take effect within one year (in the case of residential mortgage securitizations) or two years (in the case of securitizations of other assets) after publication in the Federal Register.

The provisions of the Act generally require regulators – in most cases, two or more regulators working together – to adopt regulations, which, in turn, implement the desired reform. It will be at least 270 days after the enactment of the Act before regulators promulgate most of the required regulations. In addition to a large number of mandated rulemaking exercises, the regulators are also tasked with completing a significant number of studies. These demands and capacity constraints, together with the need to coordinate concerted action by a number of regulators, may complicate the process and extend the time needed to promulgate regulations. The effective time of the regulations varies from one year after promulgation (for securitizations of asset-backed securities backed by residential mortgages) to two years (for

securitizations of all other classes of asset-backed securities), leaving a window of close to three years before the date on which certain reforms are required to become effective.

Subtitle D requires two sets of regulations governing securitizations: one of universal application, and one governing residential mortgages only. The SEC and Bank Regulators will promulgate the former set of regulations alone and the latter set in concert with HUD and FHFA. The Chairman of the newly created Financial Stability Oversight Council will coordinate all of this rulemaking activity.

Subtitle D requires the promulgation of regulations that establish asset classes and specifically govern securitizations of each of those asset classes.^v Specifically, these rules will have to incorporate underwriting guidelines established by the Bank Regulators “that specify the terms, conditions, and characteristics of a loan within the asset class that indicate a low credit risk with respect to the loan.” Thus, these regulations could subject originators that sell loans into securitizations to bank underwriting standards. Moreover, because the underwriting guidelines may dictate the level of risk retention required, these regulations would likely require sponsors of securitizations comprising higher credit risk assets to retain additional credit risk. That higher threshold would apply regardless of whether investors in such asset-backed securities would otherwise voluntarily contract to assume all of such risk in exchange for a higher return.

Additionally, the Chairman of the Financial Services Oversight Council is required to conduct a study of the macroeconomic effects of risk retention requirements (and deliver a report to Congress on the conclusions of that study) within 180 days of enactment of the Act into law. The risk retention study must include the following features:

- An analysis of the effects of risk retention on real estate bubbles, including an assessment of whether (and to what extent) a risk retention requirement would have avoided real estate-related losses in recent years,
- An analysis of whether real estate bubbles could be prevented by proactively adjusting risk

retention levels or mortgage origination requirements based on market conditions,

- An assessment of whether such proactive adjustments are properly made by an independent regulator or set by formula, whether independently or in concert with monetary policy, and
- Recommendations with respect to proper implementation and the contents of enabling legislation.

The regulatory exercise will come against the backdrop of regulatory approaches to asset-backed securitization reform that have already been in the works. As discussed above, the SEC's Regulation AB Proposal covers many of the same issues that are the subject of the Act and may serve as a head start for some of the required rulemaking. Separately, the FDIC Proposal would significantly alter a safe harbor from the exercise of FDIC receivership powers relied upon in securitizations by insured depository institutions, although the significant shortcomings of the FDIC Proposal may lead one to question whether it will be adopted as a final rule.^{vi}

Conclusion

While Subtitle D promises some form of risk retention, regulators will determine the final form of that requirement. Some asset classes, residential mortgages that conform to the regulators' specifications for low risk mortgages, for example, will be exempt from any risk retention requirements. The only certainty for participants in securitization markets coming out of the Dodd-Frank Act is the need to monitor and review proposed regulations as they are published. The key question is whether there will be anything left other than plain vanilla mortgages.

[This client alert is part of a series of alerts focused on monitoring financial regulatory reform.](#)

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ⁱ Notice of Proposed Rulemaking: Asset Backed Securities, 75 Fed. Reg. 23328 (May 3, 2010).

ⁱⁱ See Advanced Notice of Proposed Rulemaking: 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 March 31, 2010, 75 Fed. Reg. 934 (January 7, 2010); Notice of Proposed Rulemaking: 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. 27471 (May 17, 2010).

ⁱⁱⁱ The Dodd-Frank Act eliminates the Office of Thrift Supervision and moves to the OCC many of the functions and powers relative to federal savings banks that had previously accrued to that agency. These provisions are discussed in the K&L Gates Alert entitled "[A New Era: Depository Institutions and Their Holding Companies Face a Deluge of Regulatory Changes](#)," by Rebecca H. Laird, Sean P. Mahoney, and Collins R. Clark.

^{iv} The provisions of the Act related to qualified mortgages are discussed in more detail in the K&L Gates Alert entitled "[Hope You Like Plain Vanilla! Mortgage Reform and Anti-Predatory Lending Act \(Title XIV\)](#)" by Kristie D. Kully and Laurence E. Platt.

^v The asset classes contemplated by the Act include residential and commercial mortgages, commercial loans, auto loans, and any other asset classes deemed appropriate by regulators.

^{vi} A critique of an early stage of the FDIC Proposal is contained in the K&L Gates Alert entitled "[FDIC Proposes Far-Reaching Changes to the Legal Isolation Safe Harbor: New Requirements May Affect Securitization Sponsors, Servicers, and Investors](#)," by Sean P. Mahoney and Anthony R.G. Nolan.