News Bulletin

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Proposed Securitization Reforms Under the Revised Financial Reform Bill in the U.S. Senate

On March 15, 2010, Senator Christopher Dodd (D-Connecticut), Chairman of the Committee on Banking, Housing and Urban Affairs of the U.S. Senate (the "Senate Banking Committee"), released a draft of a financial reform bill to be entitled the "Restoring American Financial Stability Act of 2010" (the "Dodd Bill").

The Dodd Bill represents Senator Dodd's second proposal of major financial reform legislation during the 111th Congress. His first attempt took the form of a discussion draft, the "Restoring American Financial Stability Act of 2009," released on November 10, 2009 (the "November Senate Proposal"). One month following the release of the November Senate Proposal, on December 10, 2009, the U.S. House of Representatives passed its own version of major financial reform legislation, the "Wall Street Reform and Consumer Protection Act of 2009," often referred to as the "Wall Street Reform Act" (the "House Bill"). All three versions of proposed financial reform legislation contain provisions intended to reform the securitization markets, focusing principally on the concept of "credit risk retention" that would require originators and securitizers of financial assets to retain a portion of the credit risk of securitized financial assets or, in more popular terms, to have "skin in the game."

The final enactment of some version of these requirements appears to be some time off, notwithstanding the fact that the Obama Administration has declared the enactment of comprehensive financial reform legislation to be a top priority. Before final comprehensive financial reform legislation can be signed into law by the President, the Senate must pass its version of financial reform legislation (whether the Dodd Bill or some other version), a joint House-Senate Conference Committee would need to reconcile differences between the House Bill and the version ultimately adopted by the Senate, and a revised bill reflecting the reconciliation would need to be passed again by both Houses of Congress. Considering that many non-securitization provisions of the Dodd Bill are highly controversial and politicized, passage of financial reform legislation in the Senate may not be imminent.

Nonetheless, the securitization provisions of the Dodd Bill in many respects appear to reflect a convergence of the principles set forth in the November Senate Proposal and the House Bill, and therefore may be viewed as the most reliable indicator yet of the securitization related provisions that are likely to be contained in final financial reform legislation. The remainder of this Alert will describe the more significant securitization related provisions of the Dodd Bill and point out the principal differences between the Dodd Bill, on the one hand, and the November Senate Proposal and the House Bill, on the other hand.

Amount of Risk Retention

The Dodd Bill generally requires credit risk retention of 5% of any asset included in a securitization, or less than 5% if the assets meet underwriting standards to be established by regulation. In contrast, the November Senate Proposal would have required a credit risk retention of 10%. The House Bill also sets a baseline of credit risk retention percentage of 5% but, unlike the Dodd Bill, would permit the percentage to be increased at the discretion

of the applicable regulator, as well as decreased, based on the underwriting standards used in the origination process and the due diligence procedures used in the securitization process.

Allocation of Risk Retention Percentage Between Securitizers and Originators

The Dodd Bill imposes risk retention requirements in the first instance upon securitizers (that is, issuers and sponsors of securitizations), but allows the regulators to allocate the risk retention percentage between the securitizer and the originator of the underlying financial assets. This is a fixed-sum game—the regulators must reduce the risk retention percentage imposed on a securitizer by the percentage imposed on the originator. The Dodd Bill also sets forth factors that the regulators must consider in determining the respective percentages of risk retention to be borne by securitizers and originators.

In contrast, the November Senate Proposal applied only to securitizers and not to originators. The House Bill applies to both securitizers and originators, and appears to allow for the independent imposition of risk retention requirements on securitizers and originators, potentially resulting in the imposition of a total requirement well in excess of 5% for any particular securitization.

Asset Class Differentiation

Under the Dodd Bill, underwriting standards and the amount of risk retention may be different for different asset classes as determined by regulation. The Dodd Bill specifies the asset classes to be treated separately as residential mortgages, commercial mortgages, commercial loans, auto loans and any other class of assets that the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC") and the Securities and Exchange Commission ("SEC") deem appropriate. In contrast, neither the November Senate Proposal nor the House Bill contains provisions specifically calling for differential treatment of different asset classes.

Exemptions for Governmental Entities

The Dodd Bill does not exempt securitizations undertaken by government agencies or instrumentalities (although it does provide that the implementing regulations may exempt securitizations "as may be appropriate in the public interest or for the protection of investors"). In contrast, the November Senate Proposal exempted the U.S. government, U.S. government agencies and U.S. government sponsored enterprises ("GSEs"), presumably including Fannie Mae, Freddie Mac and Ginnie Mae, from the risk retention provisions. The House Bill similarly excludes securitizations backed by loans insured, guaranteed, administered or purchased by certain government agencies, including the Department of Education, the Department of Veterans Affairs, the Small Business Administration and Farmer Mac, but conspicuously does not exclude securitizations of Fannie Mae, Freddie Mac or Ginnie Mae or loans insured by the Department of Housing and Urban Development ("HUD") (such as FHA-insured loans).

Regulatory Agencies Responsible for Rulemaking and Enforcement

The Dodd Bill gives primary responsibility for issuing implementing regulations to the OCC, the FDIC, and the SEC. Similarly, the OCC and the FDIC are given enforcement authority with respect to risk retention requirements over bank securitizers, while the SEC is given enforcement authority over non-bank securitizers. In contrast, the November Senate Proposal gave principal regulatory responsibility to the Federal Reserve Board, a new agency to be known as the Financial Institution Regulatory Administration, and the SEC. The House Bill gives rulemaking authority to a broad range of "appropriate agencies," including the federal banking agencies, the SEC, the National Credit Union Administration Board, the Secretary of HUD and the Federal Housing Finance Agency.

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Disclosure of Repurchase Requests

The Dodd Bill provides for regulations to require securitizers to disclose both fulfilled and unfulfilled repurchase requests. In contrast, the November Senate Proposal called for securitizers to disclose fulfilled (but not unfulfilled) repurchase requests aggregated by issuer, and the House Bill calls for originators to disclose fulfilled (but not unfulfilled) repurchase requests.

Due Diligence

The Dodd Bill requires issuers of asset-backed securities to perform due diligence on the underlying financial assets and to disclose the nature of that analysis. The November Senate Proposal contained a similar provision, while the House Bill does not include any similar requirement.

Effective Date

The credit risk retention provisions of the Dodd Bill would become effective for residential mortgage-backed securities one year after adoption of final rules under the risk retention provisions of the statute, and for other asset classes two years after adoption of final rules under the risk retention provisions of the statute. There are no comparable effectiveness provisions in either the November Senate Proposal or the House Bill.

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