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Transatlantic Navigation of Securitization Reforms: A Guide

The frequency and volume of new securitization regulation being introduced in the US and the EU presents challenges. For issuers and investors, there are hidden dangers – and opportunities – that lie in divergent approaches and extraterritorial effects of the new and emerging rules. In this alert, we provide a guide to the principal EU and US securitization regulatory developments and the challenges and prospects for transatlantic securitization issuers and investors. We also include a helpful summary chart.

Reforming the Residential Mortgage Securitization Industry

Targeted US Residential Mortgage Industry Reform: The US is introducing a series of sweeping regulatory measures designed to specifically address US residential mortgage products, originators, underwriters and servicers. These are designed to improve the quality of US mortgage loans and change the systemic infrastructure of the US residential mortgage industry. These include:

- Title XIV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which requires federal regulators to:
  - establish a licensing regime for mortgage originators;
  - promulgate rules limiting pre-payment penalties on certain types of mortgages; and
  - approve regulations that would prohibit originators from approving certain types of mortgages without reasonable proof that the borrower can afford to pay off the loan.
- Proposed rules issued by US regulators in March 2011 to implement section 941 of the Dodd-Frank Act – the so-called "risk retention" proposal – will inevitably change the loan origination and underwriting business in the US. Stringent origination and underwriting standards are built into the Qualified Residential Mortgage ("QRM") exemption set forth in the proposed credit risk retention rules. The QRM exemption exempts from the 5% risk retention requirement securitizations of QRMs, which are mortgage loans that, among other requirements:
  - are subject to strict limitations on adjustable rates, loan-to-value, debt-to-income ratio, points and fees; and
  - require a downpayment of at least 20%.
- In late 2010 the Federal Deposit Insurance Corporation (the "FDIC") substantially revised its "safe harbor" securitization rule (12 CFR § 360.6) setting forth conditions that must be met by US bank securitizers to qualify for essential comfort to the rating agencies and investors that the FDIC will respect

the securitization upon the receivership of the bank. In the case of residential mortgage-backed securities ("RMBS") these conditions include required adherence to sub-prime underwriting guidelines, limitations on securitization structures to 6 tranches, prohibition of most forms of third party external credit enhancement, and the establishment of a 5% reserve fund to back representations and warranties. These rules place US bank issuers at a significant competitive disadvantage to European bank issuers.

- Proposed reforms of Fannie Mae, Freddie Mac and US mortgage servicers.

These reforms will have an impact on the assets underlying US RMBS investments made by non-US investors, and so the impact of the US sub-prime crisis on EU investors is to some extent addressed by the US reforms outlined above. However, unless a non-US originator complies with the very narrow foreign transaction exemption under the proposed Section 941 risk retention rules (requiring, among other things, that 10% or less of the issue be sold into the US), non-US originators and securitizers will have to comply with the US version of the risk retention rules. Title XIV rules will only be applicable to US mortgage originators. Also, the newly revised FDIC securitization safe harbor criteria are applicable only to US-chartered financial institutions.

Residential Mortgage Industry Not Targeted in the EU: US issuers issuing into the EU are often surprised to learn that, in contrast to the US, there have not been any EU-wide or EU member state national regulatory reforms specifically targeted at reforming residential mortgage products, originators, underwriters or servicers. While products similar to sub-prime and other non-traditional residential mortgage products exist in the EU, they have not proliferated to the extent they have in the US. While the US "sub-prime crisis" directly or indirectly impacted EU investors through direct or indirect exposure to US mortgages through their investments, the US regulatory reforms address the source of these problems – the origination and underwriting process. Thus, the European mortgage lending industry itself has not been the focus of EU reforms. US issuers of RMBS into Europe are instead impacted by EU securitization reforms of more general application relating to transparency, risk retention, due diligence and financial institution prudential standards. A number of these have direct impact on US and other non-EU issuers issuing into Europe or US and other non-EU investors investing in European transactions.

"Skin-in-the-Game" Credit Risk Retention for Securitization

EU Fixed Retention Requirement Focuses on Investor: The approach to risk retention taken in the EU (Member States were required to bring the measures into force by 31 December 2010) is different from that being proposed in the US. 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 which 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 Dodd-Frank Act, like the EU's Article 122a, includes a 5% risk retention requirement. However, the US legal requirement falls principally on the securitization sponsor, not on the investor (as in the EU). Also, in the US the 5% can be allocated between the securitizer and the originator (subject to certain limitations), whereas in the EU the retained interest must be held by one of the originator, sponsor or original lender, and cannot be divided among them.

Variations in 5% Risk Retention Requirement: The 5% risk retention in the EU is a fixed minimum within any particular jurisdiction, but may be varied from jurisdiction to jurisdiction. For example, Germany has implemented required retention of 10% rather than 5% for securitizations effected after 31 December 2014. In contrast, under the Dodd-Frank Act, regulators have the authority to increase or decrease the 5% requirement for specific asset classes or to take into account differences in underwriting standards. However, at least in the current US risk retention proposal, the regulators have determined not to attempt gradations, and propose to apply the 5% requirement uniformly to all non-exempt transactions.

US Requirements Contain Numerous Asset-Class Exemptions: The proposed US risk retention rules contain a number of asset-class exemptions, including, most notably, the QRM exemption. The US proposal also completely exempts certain types of securitizations from the risk retention. The EU's Article 122a contains extremely limited exceptions, and none of them are for QRMs or other high quality mortgage loans. In fact, the EU regulation is not structured around asset-backed securitization ("ABS") asset class categories; the only explicit EU exemptions from the risk retention rules are for:

- securitized exposures that are claims or contingent claims on or fully, unconditionally and irrevocably guaranteed by:
  - central governments or central banks;
  - regional governments, local authorities and public sector entities of Member States; or
  - multilateral development banks;
- syndicated loans, purchased receivables and credit default swaps ("CDS") which are not being used to package or hedge securitizations; and
- transactions based on a "clear, transparent and accessible" index, which is itself widely traded or is composed of securities which do not represent securitization positions.

EU/US Mismatched Timing of Implementation: The divergence in regulatory approach between the US and the EU potentially puts the US or European issuer selling ABS in Europe at a competitive disadvantage to a US issuer selling the same securities in the US, because the EU issuer may have to provide for risk retention where a US issuer is proposed to be potentially exempt due to the particular asset class. In addition, Article 122a became effective on January 1, 2011 for new securitizations issued on or after that date (and was required to be implemented in EU Member States from 31 December 2010). In contrast, the earliest dates on which the US risk retention rules will become effective are in April 2012 for RMBS and April 2013 for all other asset classes. This potentially permits a degree of regulatory arbitrage until the US retention rules become effective.

Mismatched Extraterritorial Effect: The proposed US rules include an exemption to risk retention with respect to certain predominantly foreign securitizations based on the limited nature of the securitizations' connections with the US and US investors. The safe harbor is intended to exclude from the risk retention requirements securitizations in which the effects on US interests or persons are sufficiently remote so as not to significantly impact underwriting standards and risk management practices in the US or the interests of US investors. Critically, one of the requirements for the safe harbor is that neither the sponsor nor the issuer be a US-organized entity. Accordingly, US sponsors and issuers must comply with the risk retention rate regardless of where the offering is undertaken or the investor is located. This is likely not accidental; the US suffered reputational damage in the financial crisis for exporting disastrous sub-prime loans to other parts of the world, and the US arguably has a legitimate policy interest in ensuring that its issuers sell only high quality securitization products abroad. Likewise, if European issuers are issuing into the US to sell to US investors, they will generally have to comply with the US rules.

In contrast, the EU rules apply to European investors in ABS and thus have indirect extraterritorial effect on a US issuer issuing into the EU to EU financial institutions. By prohibiting EU financial institutions from investing in securitizations unless the originator, sponsor or original lender discloses its compliance with the risk retention requirement, the rule ensures that the risk retention requirement will be met by non-EU originators looking to issue ABS to EU financial institutions.

The divergence between the effects of extraterritorial application of the US risk retention proposal and Article 122a is particularly pronounced, and places US issuers at substantial disadvantage relative to EU issuers. This disadvantage is most pronounced with respect to offerings outside of Europe or the US. Because the US rules apply to US issuers anywhere in the world, a US issuer limiting an offering to Asia or South America, for example, must comply with the US 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 in Europe, however. A US issuer issuing into Europe must apparently comply with both the US and the EU risk retention rules. Where there are differences, the US issuer presumably must observe the more restrictive provisions. In contrast, an EU issuer issuing into the US is only required to follow the US rules, and an EU issuer issuing into Europe must only comply with the EU rules. Finally, an EU issuer can sell to non-credit institutions in Europe — hedge funds, insurance companies, pension funds and corporate treasury departments — without complying with the EU rules, whereas a US issuer selling to the same EU entities must comply with the US rules.

Divergent US and EU Methodologies: The US proposal provides a variety of ways in which the 5% risk may be retained, including the following, in addition to certain transaction-specific risk retention options:

- a 5% "vertical" slice of the ABS interests;
- a 5% "horizontal" first-loss position;
- an "L-shaped interest" interest, whereby the sponsor holds at least half of the 5% retained interest in the form of a vertical slice and the rest in the form of a horizontal first-loss position;
- an amount equal to the eligible horizontal residual interest funded into a cash reserve fund account maintained by a trustee so that the sponsor experiences losses on the underlying assets as it would under an eligible horizontal residual interest; or
- a representative sample, whereby the sponsor retains a 5% representative sample of the assets to be securitized.

The US proposal also contains a controversial "premium capture rule" that generally requires that excess spread be monetized upfront in a securitization, and that the premium received be placed into a separate reserve account to absorb losses on the ABS.

In the EU, Article 122 takes a slightly different approach to risk retention methodology in that it sets out the following four ways in which the risk retention requirement can be satisfied:

- retention of no less than 5% of the nominal value of each of the tranches sold;
- in the case of securitizations of revolving exposures, retention of no less than 5% of the securitized exposures;
- retention of randomly selected exposures, equivalent to no less than 5% of the securitized exposures; or
- retention of the first loss tranche which amounts to no less than 5% of the securitized exposures.

In both the US (where risk retention has not yet been implemented) and the EU (where risk retention has already been implemented), the application of the risk retention rules to certain classes of ABS – such as collateralized loan obligations ("CLOs") and re-securitizations – remains a matter of consternation and lobbying. Market participants are hopeful that the EU and US respective exemptions and methodologies converge or, at a minimum, develop in a manner that there will be a level playing field.

ABS Registration and Offering Disclosure Reforms

ABS Disclosure and Registration Requirements: Both the US and the EU have disclosure requirements that apply to non-domestic ABS issuers. In the US, the SEC released a proposed rule on April 7, 2010 ("Reg AB II") which would significantly revise Regulation AB and other rules specifically applicable to registration, disclosure and reporting for ABS. Reg AB II would, among other things, revise the shelf offering process for ABS and require ABS issuers to provide prospective investors with significantly more time to make investment decisions. It would also revise the eligibility criteria for an issuer to use a shelf registration statement by removing the current rating criteria and adding requirements such as that issuers deliver third party opinions with regard to repurchase requests. Of considerable importance to European issuers, Reg AB II would apply many of its requirements to Rule 144A and other private placement transactions.

The EU Prospectus Directive, in contrast, has always been of general application to securities offerings (and implemented through local Member State securities laws and European exchange listing rules) and EU and local Member States do not have disclosure and registration rules specifically relating to ABS (while some European regulated exchanges may implement specific disclosure rules for ABS). It is not proposed that this European approach should change and, while the Prospectus Directive is undergoing some minor amendments, these are not expected to be significant or to be specifically directed at ABS issuance. Nonetheless, in practice, market participants anticipate that – particularly in classes of ABS where transactions are typically structured for potential simultaneous US and European offering – Reg AB II may have a practical impact on the approach to European disclosure documents and eventually there may be convergence in the form of offering documents.

Loan-Level Data Requirements: In the US, Reg AB II would require issuers to disclose specified data relating to each asset in the asset pool, obligor characteristics, and underwriting of the asset in a machine-readable, standardized format. US issuers have disclosed loan-level data for US ABS for some time, whereas this is only being brought about now in the EU in a limited manner.

On 16 December 2010, the European Central Bank (the "ECB") announced that it would begin to introduce loan-by-loan information requirements for ABS to be eligible for the Eurosystem collateral framework. Many ABS investors that are EU financial institutions require, for liquidity purposes, investments to be "eligible" even if they are not placed with the ECB upon issuance. The new requirements were mandated to be introduced in the 18-month period from December 2010, first for RMBS and thereafter gradually for other types of ABS. Some EU Member States are implementing similar measures. For example, the Bank of England ("BoE") announced on 30 November 2010 the introduction of loan-level data as part of its revised eligibility criteria for RMBS and residential mortgage-backed covered bonds accepted as collateral in its market operations. It is widely believed that these new loan-level data approaches for governmental monetary policy market operations will become the general standard for the wider European ABS market.

Divergence of Loan-Level Data Requirement Formats: The ECB loan-level data initiative aims – in a single set of European-wide ABS data templates – to reconcile divergences in local EU Member State laws and practices in relation to various ABS classes. Some market participants already are grappling with apparent differences between the data fields and templates as between the local Member States, in contrast to the ECB approach – for example, differences remain to be reconciled between the BoE and the ECB RMBS loan-level data templates.

As between the US and the EU, the ECB loan-level data templates will cover different fields of information to the US forms. One obvious difference is that the US versions may require disclosure of the borrower's Fair Isaac Corporation ("FICO") credit score, whereas the EU will not (as FICO is not a European concept). Also, under proposed US reforms, additional loan-level disclosures would now be required, including information regarding repurchase requests for breach of representations and warranties, for which there is no comparable regulation in the EU.

EU and US issuers issuing securities into the other or both jurisdictions will therefore potentially need to disclose their asset pools (in disclosure schedules and data tapes) either according to each convention or according to a "highest common denominator" format designed to meet legal requirements and investor conventions in all relevant jurisdictions.

Specific US Disclosure Measures: The US has introduced certain ABS disclosure regulations in relation to disclosure which have no corollary in the EU, most notably:

- Under Reg AB II, it is proposed that issuers must file a computer program for the priorities of payments "cash-flow waterfall" which would permit prospective investors to input data regarding the pool assets and model projected cash flows and allocation of losses.
- Pursuant to the Dodd-Frank Act, the SEC adopted a rule amending the Securities Exchange Act of 1934, as amended (the "Exchange Act") known as the "Reps and Warranties Rule". The rule requires securitizers who have issued ABS during the three-year period ending December 31, 2011 that include a covenant to repurchase or replace an underlying asset for breach of a representation or warranty to make certain additional filings.
- Rule 17g-7 requires each nationally recognized statistical rating organization ("NRSRO") issuing a credit rating on an ABS to provide a description of the representations and warranties and enforcement mechanisms in any report it issues accompanying a credit rating of any ABS. Also, the NRSROs rating the ABS must compare the representations and warranties in the transaction being rated to those in other issuances of similar securities offered by the same issuer and other issuers in the industry.

Due Diligence Reforms

Issuer-Based Approach in the US vs. Investor-Based Approach in the EU: Although both the US and EU regulatory reforms have similar objectives in terms of improving the standard of disclosure and due diligence in securitization transactions, they have approached the issue from different angles. The US reforms put the legal responsibility on the sponsors and originators, whereas the EU reforms put the responsibility on investors. The EU CRD II imposes extensive due diligence obligations on EU banks investing in securitizations, whether originated in the EU or the US. The obligations apply both before making an investment and during the life of that investment. CRD II Article 122a(4) provides that an investing bank must be able to demonstrate to its regulator, in respect of each securitization position it holds, that it has "a comprehensive and thorough understanding" of each of a range of specified matters; and that it has implemented formal policies and procedures "commensurate with the risk profile of its securitization investments" for analyzing and recording such matters. A failure to comply will result in unfavorable capital treatment and is not a regulatory violation.

Issuer Review Rule in the US: Rule 193 and amended Item 1111 of Regulation AB under the Securities Act require an issuer or independent third party to perform a review of the assets underlying an ABS in a registered transaction and to disclose the result of such review in the prospectus (the so-called "Issuer Review Rule"). This is provided that (i) the third party is named in the registration statement and consents to being named an "expert", subjecting the third party to expert liability under Section 11 of the Securities Act; or (ii) the issuer attributes to itself the findings and conclusions of the independent third party review. This applies to any issuer issuing into the US, regardless of its country of organization. There is no EU corollary to the US Issuer Review Rule; the market is poised to observe whether, in practice – particularly in classes of ABS where transactions are typically structured for potential simultaneous US and European offering – the Issuer Review Rule may have a practical impact on the expectations of European investors and eventually result in convergence in the EU and US approach.

Credit Rating Agency Reforms

Expert Liability in the US: The Dodd-Frank Act repealed Rule 436(g) of the Securities Act which resulted in the creation of expert liability for NRSROs, in order to increase accountability and accuracy of ratings. However, this led to rating agencies refusing to permit issuers to include credit ratings in their offering documents. The SEC has had to temporarily suspend the credit rating requirement for registered ABS as a result of the NRSROs' refusal. There is no corollary in the EU. The Dodd-Frank Act also mandates studies and reports on how to further eliminate credit rating related conflicts of interest, including eliminating the use of credit ratings.

US "Issuer Website" Rules: Securities Act Rules 17g-2 and 17g-5 have been amended to require NRSROs to disclose more credit rating history information and disclose information relating to an initial rating provided by an issuer to certain non-hired NRSROs. The amended rules also require issuers to provide information to both hired and non-hired NRSROs. Non-US credit rating agencies or branches of US credit rating agencies that are not registered with the SEC as NRSROs are not subject to the regulations. In addition, even in the case of NRSROs regulated by Rule 17g-5, ABS issued by non-US issuers to non-US persons are exempt from the application of the rule until 2 December 2011.

"Issuer Website" Rule Voted Down in the EU: In the EU, Article 8 of the amendment to the CRA Regulation EC 1060/2009 proposed that issuers of structured finance instruments (or related third parties) must give non-hired EU credit rating agencies access to the same information they give to the EU credit rating agency they hire to rate the instrument. This was similar to Rule 17g-5 in the US, but was voted down, apparently heavily influenced by the observation that, in the US, the rule did not have the intended effect of generating competitive unsolicited ratings, but had only added to the administrative cost and burden of effecting a securitization. Given these divergent developments on the parallel Rule 17g-5 and Article 8 reforms, it will be interesting to see what coordination action is taken (if any) as between the SEC and/or the European Parliament when the exemption for non-US ABS comes to an end on 2 December 2011.

Conclusion

There are many differences in the generally parallel emerging US and EU securitization regulating regimes that lead to incongruous outcomes when applied to US and EU issuers seeking to issue ABS into the "other" jurisdiction or seeking to issue simultaneously into both markets. The complexity of reconciling and navigating these requirements poses a challenge to the re-establishment of efficient securitization markets. It remains to be seen whether lawmakers, policy makers and regulators on both sides of the Atlantic will recognize the cost and burden of this situation and move towards true convergence to ensure a level playing field.

Summary Chart: EU and US Securitization Reforms

Topic	US	EU
Mortgage Loan Quality	• Targeted US residential mortgage industry reforms for originators, products, servicers	• No targeted mortgage loan reforms
Credit Risk Retention	• Obligation on securitizers and originators • 5 methods of retention • L-shaped retention • Limited sharing of retained interest permitted • Many asset class exemptions • Limited foreign safe harbor • Proposals effective in 2012/13	• Obligation on EU financial institution investors to monitor compliance by securitization sponsors, originators and original lenders • 4 methods of retention • No L-shaped retention • No sharing of the retention • Limited exemptions • Applies to foreign issuers • Implemented law
ABS Registration and Offering Disclosure Requirements	• Proposed revised shelf offering process and eligibility criteria • Proposed asset-level data • Proposed waterfall computer program • Reps and Warranties Rule filings • Rating agency comparison of reps and warranties	• No ABS changes under Prospectus Directive • ECB loan-level data • Member State loan-level data • Different fields of information, such as no FICO score
Due Diligence	• Obligation on issuer • Issuer Review Rule	• Obligation on investor (if an EU financial institution) • No Issuer Review Rule
Credit Rating Agencies	• Expert liability for rating agency • Rule 17g-5 rating agency “Issuer Website” rule	• No statutory expert liability for rating agency • Proposed Article 8 CRA Regulation “Issuer Website” rule voted down • Exemption of non-US ABS from US “Issuer Website” rule expires 2 December 2011

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