

Securitisations and other Structured Finance Transactions

What is the Outlook for the Market?

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Outline

- Regulatory changes affecting the securitisation/structured credit market
 - Basel II/III
 - Capital Requirements Directive (EU)
- Developments in US legislation and regulation
- IOSCO ABS disclosure principles
- Latest developments in the regulation of credit rating agencies
- Outlook for the market

Basel Framework and Securitisation

- Original Accord published in 1988
- Basel II Accord published in June 2004 provided a more sophisticated and risk sensitive method of calculating a financial institution's capital requirements
- Various amendments to Basel II Accord between 2005 and 2009
- Material amendments to Basel II Accord published in January and July 2009 which have a significant impact on securitisation. Some adjustments to these proposals were published by the Basel Committee in June 2010.
- Basel III consultative document published in December 2009 and updated in July 2010
- Announcement on 12 September 2010 that agreement had been reached on Basel III amendments

Basel II – July 2009 Papers

- Enhancements to the Basel II framework
 - contains new guidelines for resecuritisations, liquidity facilities and Pillar 3 disclosures
- Revisions to the Basel II market risk framework
 - includes changes to trading book and capital charges for securitisation positions
- Guidelines for computing capital for incremental risk in the trading book

Implementation of Basel II/III

- Basel Accord is not directly enforceable against banks and other financial institutions
- In the EU, the Accord is implemented by the Capital Requirements Directive (CRD)
- Recent amendments/additions to the CRD include:
 - CRD II, dated 16 September 2009 (including own funds, large exposures, supervisory arrangements, 5% risk retention requirement and rules on hybrid capital)
 - CRD III, expected to be approved by EU Council in October 2010 (including rules on resecuritisation, trading book capital requirements and executive remuneration)
 - Technical Changes Directive of 27 July 2009 (including rules on significant risk transfer and conversion factors for liquidity facilities)
 - CRD IV, will include measures included in Basel III (including definition of capital, liquidity standards, leverage ratios, counterparty risk, countercyclical measures, capital requirements for foreign currency mortgages and removal of some national discretions)
- In the U.S., legislation will be needed to implement Basel II and Basel III. Some provisions are included in the Dodd-Frank legislation

New Resecuritisation Rules

- These are contained in both Basel II and CRD III
- Rules were to come into effect on 1 January 2011
- In June 2010, revisions to the Basel proposals delayed the commencement date to 31 December 2011. This is likely to be replaced in CRD III
- Special rules for resecuritisations are considered necessary due to their complexity and sensitivity to correlated losses
- CEBS advice to the EU Commission in November 2009 identified uncertainties regarding the practical implication of some of the arrangements

New Resecuritisation Rules (cont.)

- Basel paper defines a resecuritisation exposure as one where:
 - the risk associated with an underlying pool of exposures is tranced
 - at least one of the underlying exposures is a securitisation exposure
- An exposure to one or more resecuritisation exposures is also a resecuritisation
- CRD III largely tracks this definition of resecuritisation
- Definition will cover:
 - CDOs of ABS
 - tranced deals where the pool includes any rmbs or cmbs security, etc.
 - credit derivatives providing credit protection for a resecuritisation exposure

New Resecuritisation Rules (cont.)

- ABCP programme analysis is not straightforward
- Guidance in Basel II and CRD III provides:
 - a liquidity facility to an ABCP programme should generally not be a resecuritisation position where it covers 100% of the assets (and is a single tranche) and none of the assets in the pool is a resecuritisation position
 - a programme-wide credit enhancement facility which covers only some losses across the various pools of assets in the programme would be a tranching of risk and therefore a resecuritisation position
 - CP issued by an ABCP conduit should not be a resecuritisation position provided there is a single tranche of CP and either:
 - the programme-wide credit enhancement is not a resecuritisation or
 - the CP is fully supported by the sponsoring bank so that the external rating of the CP is based primarily on the credit quality of such sponsor

New Resecuritisation Rules (cont.)

- Risk weightings of a resecuritisation exposure under both the standardised and IRB methods is increased
- The 1,250% risk weight ceiling continues to apply to both securitisations and resecuritisations
- For banks applying the supervisory formula method there is a minimum risk weighting of 20% for resecuritisations (the minimum is 7% for securitisations)

New Resecuritisation Rules (cont.)

Comparative Risk Weightings for the standardised approach

Long term rating

Rating	Securitisation Exposures	Resecuritisation Exposures
AAA to AA	20	40
A+ to A-	50	100
BBB+ to BBB-	100	225
BB+ to BB-	350	650
B+ and below or unrated	Deduction	Deduction

Short term rating

Rating	Securitisation Exposures	Resecuritisation Exposures
A-1/P-1	20	40
A-2/P-2	50	100
A-3/P-3	100	225
All other ratings or unrated	Deduction	Deduction

New Resecuritisation Rules (cont.)

- There are transitional provisions under CRD III:
 - the new risk weightings currently apply to resecuritisations issued after 31 December 2010
 - they will apply to existing resecuritisation positions after 31 December 2014 if new underlying exposures are added or substituted after that date
- EU Commission proposals for more stringent requirements for “highly complex resecuritisations” have been dropped for the time being

Risk Retention Rules

- Neither Basel II nor the Basel III proposals currently contain a risk retention requirement
- Both CRD II and the US Dodd-Frank legislation include a 5% risk retention requirement
- There are however some differences between the approach in CRD II and Dodd-Frank
- CRD II, introduces a new Article 122a to the CRD which contains the EU risk retention requirements
- Article 122a (1) provides that:

“a credit institution, other than when acting as an originator, a sponsor or original lender, shall be exposed to the credit risk of a securitisation position in its trading book or non-trading book only if the originator, sponsor or original lender has explicitly disclosed to the credit institution that it will retain, on an ongoing basis, a material net economic interest which, in any event, shall not be less than 5%.”

Risk Retention Rules (cont.)

- Under Article 122a(1) there are four alternative methods by which the 5% net economic interest may be retained
 - vertical slice – a retention of at least 5% of the nominal value of each tranche
 - originator's interest – in relation to revolving exposures, at least 5% of the nominal value of the securitised exposures
 - random selection – where there are at least 100 potential exposures, a retention of exposures that have been randomly selected and which have a nominal value of at least 5% of the nominal value of the securitised exposures
 - first loss tranche – retention of a first loss tranche having at least the same risk profile as other tranches and not maturing earlier than tranches sold to investors and which equals at least 5% of the nominal value of securitised exposures

Risk Retention Rules (cont.)

- The retained net economic interest must be maintained on an ongoing basis
- The retained interest must not be sold or hedged or be subject to any credit risk mitigation
- The retained interest must be held by one of the originator, sponsor or original lender and cannot be divided between them
- There are some exemptions to the retention requirement including:
 - certain transactions based on a clear, transparent and accessible index where the underlying entities are widely traded
 - syndicated loans, purchased receivables or credit default swaps not used to package and/or hedge a securitisation covered by 122a(1)
- The rules apply to new securitisations issued on or after 1 January 2011 and after 31 December 2014 to existing securitisations where new underlying exposures are added or substituted after such date

CRD II – Disclosure Requirements

- New disclosure requirements apply to new securitisations issued on or after 1 January 2011
- They also apply to existing securitisations from 31 December 2014 if there is a substitution or addition of assets after that date
- Sponsors and originator banks must disclose to investors the level of their retention of exposure under Article 122a(1)

CRD II – Disclosure Requirements (cont.)

- Sponsors and originator banks must also ensure that investors and prospective investors have readily available access to:
 - all materially relevant data on (i) credit quality and performance of the individual underlying exposures and (ii) cashflows and collateral supporting the underlying exposures
 - such information as is necessary to conduct comprehensive and well-informed stress tests on the cashflows and collateral values supporting the underlying exposures
- Sponsors and originators also have an ongoing obligation to deliver all such information as is appropriate due to the nature of the securitisation
- Any material breach of the disclosure obligation in CRD II requires the relevant regulator to apply an additional risk weight of at least 250% to the securitisation position (with cumulative increases for further breaches) subject to a maximum of 1,250%

Basel/CRD III Disclosure Requirements

- The July 2009 Basel Enhancements Paper and CRD III further increase the disclosure obligations.
- The Basel amendments include additional Pillar 3 disclosure obligations. These are very detailed and include:
 - a description of the types of assets underlying the securitisation
 - the nature of other risks, e.g. liquidity risk inherent in securitised assets
 - a description of the processes in place to monitor changes in the credit and market risk of securitisation exposures
 - a description of the bank's hedging policy in respect of retained and resecuritisation exposures including the identity of material hedge counterparties
 - a summary of the bank's accounting policies for securitisation activities
 - the aggregate amount of assets of the bank intended to be securitised
 - the aggregate amount of resecuritisation exposures
- There are separate requirements for both the banking book and trading book
- The Basel amendments are reflected in CRD III

Basel/CRD II – Investor Due Diligence Requirements

- New investor due diligence rules apply to new securitisations issued on or after 1 January 2011
- They also apply to existing securitisations from 31 December 2014 if there is a substitution or addition of assets after that date
- The rules are introduced to seek to meet concerns that many investors in securitisations did not undertake adequate due diligence as to the risks being acquired and relied principally on the credit rating
- The new rules apply both prior to the investment and during the time it is held

Basel/CRD II – Investor Due Diligence Requirements (cont.)

- CRD II introduces a new Article 122a(4) to the CRD
- Credit institutions holding securitisation positions must be able to demonstrate to the relevant competent authority that it has a comprehensive and thorough understanding of and has implemented formal policies and procedures for both banking and trading book commensurate with the risk profile of their investment in securitised positions for analysing and recording certain matters including:
 - information disclosed by originators or sponsors as to the net economic position retained in the securitisation
 - the risk characteristics of the securitisation position
 - the risk characteristics of the exposures underlying the securitisation
 - the reputation and loss experience in earlier securitisations of the originators or sponsors in the relevant exposure class underlying the securitisation
 - statements and disclosures by the originator or sponsor about their due diligence on the securitisation exposures and related collateral
 - relevant methodologies and concepts on which the valuation of supporting collateral is based
 - relevant market structural features of the securitisation

Basel/CRD II – Investor Due Diligence Requirements (cont.)

- Credit institutions are also required to regularly perform their own stress tests appropriate to their securitisation positions
- Under new Article 122a(5) to the CRD, except where acting as originator or sponsors or original lenders, credit institutions shall establish formal procedures appropriate to their banking and trading books and commensurate with the risk profile of their investment in securitised positions to monitor on an ongoing basis and in a timely manner, performance information on the exposures underlying their securitisation positions including:
 - exposure type
 - percentage of loans more than 30/60/90 days past due
 - default and prepayment rates
 - loans in foreclosure
 - collateral type and occupancy
 - industry and geographical diversification

Basel/CRD II – Investor Due Diligence Requirements (cont.)

- Credit institutions are also required to have a thorough understanding of all structural features of a securitisation that would materially impact the performance of their exposures to the transaction including the payment waterfall and credit and liquidity enhancements
- Firms which fail to comply with the above requirements are subject to an additional capital charge to be imposed by the relevant competent authority of at least 250%, subject to an overall cap of 1,250%
- Under new Article 122a(6) of the CRD, sponsors and credit institutions shall apply the same criteria for credit granting to assets regardless as to whether the assets are to be securitised or held on its own book
- Non compliance with Article 122a(6) will result in the securitised assets being treated as remaining on its balance sheet

Significant Credit Risk Transfer

- Under both CRD and Basel II, for an originator to treat securitised assets as having been removed from its balance sheet for regulatory capital purposes a “significant credit risk” in those assets must have been transferred
- No previous guidance as to “significant credit risk” transfer in the CRD
- Approach has been inconsistent among national regulators
- Under the Technical Changes Directive to take effect from 31 December 2010, a significant credit risk will be deemed to have been transferred if any of the following applies:
 - the originator makes a full deduction in relation to all the securitisation positions it holds in the relevant securitisation
 - the originator does not retain more than 50% of all mezzanine positions
 - if no mezzanine position, the originator does not hold more than 20% of the first lost piece
 - if permitted by its regulator, the originator makes its own assessment

Basel II/CRD III – Risk Weighting of Liquidity Facilities

- Under the standardised approach, Basel II and the CRD previously provided the following credit conversion factors for the liquidity facility for a securitisation transaction meeting certain criteria:
 - 0% for a facility that can only be drawn in the event of a general market disruption
 - 20% for a facility with a maturity of no longer than one year
 - 50% in all other cases
- Under the Basel Enhancements Paper and the Technical Changes Directive, the credit conversion factor for all such liquidity facilities will be 50%
- The 20% credit conversion previously applicable under the IRB method to market disruption facilities has also been removed
- These amendments have effect from 1 January 2011

CRD II – Large Exposures

- Under existing EU large exposure rules:
 - a bank's aggregate exposure to any one client or group of connected clients must not exceed 25% of its own funds
 - the aggregate of all its individual large exposures (a value equal to or in excess of 10% of its own funds) must not exceed 800% of its own funds
- CRD II amends definition of “group of connected clients” in Article 4(45)(b) of the CRD
- The new definition provides that a group of connected clients exists between two or more parties between whom there is no relationship or control but:

“who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, in particular funding or repayment difficulties, the other or all of the others would also be likely to encounter funding or repayment difficulties.”
- Intended to have particular impact on ABCP structures

Other Relevant Changes in Basel II/CRD III

- Capital requirement of securitisation positions in the banking and trading books will be the same
- External ratings used by a bank to calculate capital requirements for any securitisation exposure must not be based on any unfunded credit or liquidity support it provides
- Treatment of rules for correlation trading exposures subject to 8% floor

Special Purpose Entities

- Joint Forum of the Basel Committee published a report on special purpose entities in September 2009
- Aim of the report was to suggest policy implications and issues for consideration by supervisors and market participants
- Recommendations included:
 - supervisors should ensure market participants assess all economic risks and business purposes of an SPE throughout the life of a transaction distinguishing between risk transfer and risk transformation
 - market participants should be able to assess and manage factors that increase transaction complexity
 - firms should monitor on an ongoing basis the quality of transferred exposures in relation to the risk profile of the firm's remaining portfolios and the impact on its balance sheet components
 - If there is a likelihood or evidence of support by the originator, etc., including non contractual support, the activities of the SPV should be aggregated with those of such entity for both supervisory assessment and internal risk management purposes
 - Supervisors should support greater standardisation of definitions, documentation and disclosure requirements for SPE transactions
 - Supervisors should regularly oversee and monitor the use of SPE activity and seek to identify developments that could lead to systemic weakness and contagion or exacerbate procyclicality

Developments in US Legislation and Regulation

- Regulation AB
- Dodd-Frank Act
- FAS 166 and 167
- FDIC Proposed Securitisation Safe Harbour
- HIRE Act

Regulation AB

- The main rule governing disclosure for public securitisations in the US
- In April 2010, the SEC proposed widespread modifications (“Proposed Rule”) to Regulation AB to implement more extensive disclosure requirements for securitisation issuers
- Proposed Rule revises filing deadlines in shelf offerings to provide investors with more time to analyse transaction-specific information before making their investment decision
- Removes the ability to file a registration statement with more than one base prospectus/prospectus supplement

Regulation AB – Shelf Registration

- For each issuance from a shelf programme, a preliminary prospectus
 - would need to be filed at least 5 business days prior to the first sale of securities in the offering
 - would be required to be structured as a unitary prospectus (as opposed to a base prospectus plus supplement)
 - would need to include all the information omitted from the form of prospectus in the registration statement, other than pricing information
- Final prospectus including pricing information would need to be filed within 2 business days of the pricing date
- Now, though, a material change to the information in the preliminary prospectus would require a new preliminary prospectus and a new 5-business day waiting period

Regulation AB – Shelf Registration (cont.)

- With both the preliminary and final prospectuses, asset-level data would need to be filed, as well as a computer programme that gives effect to the cashflow waterfall provisions of the issuance
- In addition, broker-dealers would no longer be exempt from the 48-hour waiting period required between providing a potential investor with the preliminary prospectus and sending them a confirmation of sale. Previously they were exempt under Rule 15c2-8(b) of the Exchange Act

Regulation AB – Shelf Registration (cont.)

- Reg AB sets out various eligibility criteria for use of shelf registration for ABS issuance and one of these criteria is the requirement for credit ratings to be obtained
- Proposed Rule keeps all these criteria in place, except that it allows for the relaxation of the credit rating requirements if:
 - there is credit risk retention equal to at least 5% of the securities issued
 - there is certification by the CEO of the originator at time of each offering of a shelf registration statement of belief that the pool assets will produce sufficient cashflow to service all payments on the notes, taking into account all internal credit enhancements
 - the originator (or other party required to repurchase the assets upon a breach of rep or warranty) has an obligation in the pooling and servicing agreement to provide an independent third party opinion, at least quarterly, as to whether it has acted consistently with its obligations regarding any loans put back to the originator which were not repurchased
 - there is an undertaking by the issuer to file Exchange Act reports so long as non-affiliates of the originator hold any securities sold in registered transactions backed by the same pool of assets

Regulation AB - Disclosure Requirements

- Issuers must disclose specific data relating to the asset pool, obligor characteristics and the underwriting of the asset
- Information required is split up by asset class i.e. residential mortgages, commercial mortgages, auto loans, equipment loans, student loans, resecuritisations and corporate debt, with separate requirements prescribed for credit card receivables
- In general, the following is required:
 - for certain originators, information relating to the amount of the originator's publicly securitised assets that, in the last three years, has been the subject of a demand to repurchase or replace
 - additional information regarding originators and sponsors
 - descriptions relating to static pool information, such as a description of the methodology used in determining or calculating the characteristics of pool performance
 - the filing of a Form 8-K for a 1% or more change in any material pool characteristic from what is described in the prospectus (instead of 5%)

Regulation AB – Disclosure Requirements (cont.)

- Asset level data must be filed in a standardised, machine – readable format and needs to be provided with the filing of the preliminary prospectus, filing of the final prospectus, upon new assets being added to the asset pool and on an ongoing basis
- Issuers must also file a computer programme, in the form of downloadable source code in Python (a computer programming language which allows the user to programmatically input information from the asset data file and conduct their own evaluations of the ABS securities)
- This program has to be filed with the SEC with the preliminary and final prospectuses, and can attract liability in the same way as the prospectuses
- It will no longer be sufficient to maintain all the information required by Reg AB on the issuer's/sponsor's website and it will have to be submitted to the SEC and posted on EDGAR

Regulation AB – Private Offerings of ABS

- Non-public ABS transactions (such as Rule 144A placings) will now require the issuer to provide the same level of information to investors upon request as is required of issuers of registered public deals
- The transaction documents will be required to contain an obligation of the issuers to the above effect – therefore a failure to supply such requested information would now give rise to an investor claim for breach of contract, as well as SEC enforcement action
- This provision of the Proposed Rule is especially relevant to foreign issuers of “structured finance products” (defined later), as it applies to all private placings of ABS by foreign issuers into the US
- Issuers into the US under Rule 144A would also need to file a newly-created Form 144A-SF with the SEC no later than 15 days after the first sale of securities in the offering

Regulation AB – Definitions

Asset Backed Security:

- a security primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to the security holders; provided that in the case of financial assets that are leases, those assets may convert to cash partially by the cash proceeds from the disposition of the physical property underlying such leases

Structured Finance Product:

- a synthetic asset-backed security or
- a fixed-income or other security collateralised by any pool of self liquidating financial assets, such as loans, leases, mortgages, and secured or unsecured receivables, which entitles the security holders to receive payments that depend on the cash flow from the assets, including:
 - an asset-backed security
 - a collateralised mortgage obligation
 - a collateralised debt obligation (“CDO”)
 - a collateralised bond obligation
 - a CDO of asset-backed securities
 - a CDO of CDOs (or “CDO-squared”)
 - any other security that at the time of the offering is commonly known as an asset-backed security or a structured finance product

Dodd-Frank Wall Street Reform and Consumer Protection Act

- Risk Retention
- Disclosure and Underwriting Standards
- Conflicts of Interest
- Penalties

Risk Retention

- Dodd-Frank (“DF”) lays down rules instructing applicable federal regulators to issue rules requiring “securitisers” in Asset Backed Securities to retain at least 5% of the credit risk of the assets transferred in connection with the ABS issuance (or in the case of CDO’s, synthetic CDO’s and other instruments collateralised by ABS, a 5% residual interest in the underlying part of assets backing the securities)
- Asset Backed Security:
 - (A) means a fixed-income or other security collateralised by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including:
 - (i) a collateralised mortgage obligation
 - (ii) a collateralised debt obligation
 - (iii) a collateralised bond obligation
 - (iv) a collateralised debt obligation of asset-backed securities
 - (v) a collateralised debt obligation of collateralised debt obligations
 - (vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section

and

- (B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company

Risk Retention (cont.)

- Securitiser means:
 - (A) an issuer of an asset-backed security or
 - (B) a person who organises and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer
- Originator means a person who:
 - (A) through the extension of credit or otherwise, creates a financial asset that collateralises an asset-backed securityand
 - (B) sells an asset directly or indirectly to a securitiser

Risk Retention (cont.)

- A securitiser is prohibited from hedging or otherwise transferring any part of the credit which it is required to retain
- DF allows for regulators to set a minimum retention of less than 5%, if the assets meet certain underwriting standards
- These standards are to be established by the federal banking agencies (Office of the Comptroller of the Currency, Governors of the Federal Reserve and the FDIC) and the SEC
- Different rules are to be established for assets, and securitisers, of different classes:
 - Residential mortgages
 - Commercial mortgages
 - Commercial loans
 - Auto loans
 - Other classes of assets deemed appropriate.
- For each of the above asset classes, the underwriting standards to be developed by the regulators will set out the terms, conditions and characteristics for the relevant asset class that equate to a low credit risk

Risk Retention – Exemptions

- DF provides that ABS backed by “qualified residential mortgages” shall be exempt from the credit risk retention requirements
- “Qualified residential mortgages” is to be defined jointly by the federal banking agencies, the SEC, the Secretary of Housing and Urban Development and the Director of the Federal Housing Finance Agency. It is intended to be defined so as to include only assets whose features indicate a historically lower risk of default
- Features to be considered for this purpose:
 - verification of mortgagor’s financial resources
 - standards as to:
 - mortgagor’s residual income after all outgoings
 - ratio of mortgagor’s housing payments/income
 - ratio of mortgagor’s monthly instalment payments/income
 - mitigation of “migration risk” on adjustable rate mortgages
 - mortgage guarantee insurance or similar insurance/credit enhancement
 - restricting use of balloon payments/negative amortisation/prepayment penalties/interest-only payments and other “higher risk” features
- The “qualified residential mortgage” exception does not apply where an ABS security is collateralised by tranches of other ABS

Risk Retention – Exemptions (cont.)

- The development of this particular exception by the regulators is likely to be one of the most closely watched processes in Dodd-Frank
- DF provides that the regulators may not allow the definition to be any broader than the definition of “qualified mortgage” in section 129(c)(2) of the Truth in Lending Act, as amended by the Consumer Financial Protection Act of 2010
- DF also allows the regulators to create additional exemptions from the credit risk retention requirements if:
 - this is in the public interest and is done for the protection of investors
 - the exemption will ensure high quality underwriting standards for the securitisers and originators of the securitisation assets
 - the exemption will encourage appropriate risk management practices by the securitisers and originators of assets, improve consumer and business access to funds on reasonable terms, or otherwise is in the public interest and is done for investor protection

Risk Retention – Exemptions (cont.)

- Certain institutions and programmes are exempt from the credit risk retention requirements, including a securitisation of assets which are insured or guaranteed by any US agency. The Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation are not considered US agencies for this purpose
- The regulators are also specifically empowered to exempt ABS issuances by US agencies, other sovereign states/territories and their political sub-divisions or public bodies
- The regulators are charged with prescribing the necessary regulations to implement the DF provisions on credit risk retention, within 270 days of enactment of DF (i.e. by 18 April 2011)
- DF leaves it up to the regulators to specify how the credit risk retention should be effected. For instance, DF does not specify whether the retention should take the form of a first-loss piece or a vertical slice of each tranche or some other methodology

Risk Retention – Exemptions (cont.)

- Where a securitiser purchases assets from an originator, DF empowers regulators to allocate the total risk retention requirements between the securitiser and the originator, so long as between them they retain the minimum 5% requirement (or such lower percentage as the regulators may have prescribed pursuant to their discretions mentioned earlier)
- Only in respect of CMBS does DF provide guidance as to the permissible types, forms and amounts of risk retention that regulations may consider. These include:
 - retention of a specified amount or percentage of the total credit risk of the asset
 - retention of the first-loss position by a third-party purchaser that specifically negotiates for the purchase of such first loss position, holds adequate financial resources to back losses, provides due diligence on all individual assets in the pool before the issuance of the asset-backed securities, and meets the same standards for risk retention as the Federal banking agencies and the SEC require of the securitiser
 - a determination by the federal banking agencies and the SEC that the underwriting standards and controls for the asset are adequate
 - provision of adequate representations and warranties and related enforcement mechanisms

Comparison of US/European “skin-in-the-game” provisions

Similarities

- Amount – 5%, although possibility of this being increased in Europe by European Commission, and in US, discretion of regulators to reduce this percentage
- Certain exceptions, such as issuances by certain governmental entities
- Prohibition on hedging/passing off the credit risk retention

Differences

- European rules apply on basis of controlling what credit institutions invest in, whereas DF directly imposes the obligations on the securitiser
- In Europe the credit risk has to be retained by the originator/sponsor/original lender. In US, it can be allocated between originator/sponsor and the issuer
- In Europe, section 122a of CRD provides for only a limited number of exceptions to the risk retention rules. In the US, there is a specific exception for certain residential mortgage backed securities, as well as broad discretion for regulators to make additional exemptions
- In Europe, retention provisions apply to new securitisations issued on or after 1 January 2011, and from 31 December 2014 in the case of existing securitisations where new assets are added after such date. In US, retention rules will be effective for RMBS from April 2012 and for other asset classes from April 2013

Dodd-Frank – Disclosure and Underwriting Standards

- Similarities with proposed revised Regulation AB
- DF requires issuers of ABS to disclose, for each tranche or class of security, information regarding the assets backing that security
- Disclosure shall include asset-level or loan-level data sufficient to enable investors to conduct their own due diligence on the assets
- Such data shall include:
 - data having unique identifiers relating to loan brokers or originators
 - the nature and extent of the compensation of the broker or originator of the assets backing the security
 - the amount of risk retention by the originator and the securitiser of such assets
- DF provides that regulators will require securitisers to disclose both fulfilled and unfulfilled purchase requests, to enable investors to “identify asset originators with clear underwriting deficiencies”

Dodd-Frank – Disclosure and Underwriting Standards (cont.)

- DF requires credit rating agencies to include in their credit rating reports a description of:
 - the representations and warranties and enforcement mechanics available to investors
 - how these differ from the representations, warranties and enforcement mechanics in issuances of similar securities
- As to ongoing disclosure, a class of a registered issuance of ABS was previously exempt, after one year, from the Section 15(d) Securities Exchange Act 1934 reporting requirements, if the securities of that class were held by fewer than 300 investors
- Effective immediately, this exemption has been removed both in respect of future ABS issuances, and also pre-existing issuances (even where the issuer has already ceased to report, based on the previous exemption)
- DF also requires securitisers to perform due diligence on the underlying assets and to disclose the nature of that analysis in their registration statements

Dodd-Frank – Conflicts of Interest

- For one year after the date of the first closing of the sale of an asset-backed security, the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary thereof is prohibited from engaging in any transaction that would involve a material conflict of interest with respect to any investor in a transaction arising out of such activity
- Exceptions to the general prohibition:
 - hedging activities designed to mitigate the specific risks of underwriting, placement, initial purchase, or sponsorship of an asset-backed security
 - purchases or sales to provide liquidity for an asset-backed security made pursuant to and in connection with commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary thereof
 - bona fide market making in the asset-backed security

Dodd-Frank – Penalties

- DF does not prescribe specific penalties for failure to comply with the conflict of interests provisions, but the regulators are empowered to prescribe such penalties as part of the regulations to be implemented
- The penalties will be enforced by the FDIC or relevant federal banking authority for a securitiser that is an insured depository institution, and by the SEC for other types of securitisers

FAS 166 and 167

- On June 12, 2009, the Financial Accounting Standards Board (the “FASB”) adopted Statement of Financial Accounting Standards No. 166, Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140 (“FAS 166”), and Statement of Financial Accounting Standards No. 167, Amendments to FASB Interpretation No. 46(R) (“FAS 167”)
- These new statements substantially narrow the circumstances under which a transfer of financial assets in connection with a securitisation may be accounted for as a sale, and expand the circumstances under which insured depository institutions are required to consolidate SPV issuers, in their financial statements
- These standards became effective for fiscal years beginning after November 15, 2009. (For most institutions, the new GAAP rules became effective on January 1, 2010)
- These changes will cause many securitisation transfers that previously would have been treated as sales to be treated as secured borrowings for accounting purposes

FDIC Proposed Securitisation Safe Harbour

- As a result of FAS 166 and 167, FDIC-insured depository institutions that have entered into securitisations using a special purpose vehicle will now be required, in most cases, to include the securitised assets on their consolidated balance sheet
- As a consequence, the securitised assets would become the property of the FDIC if the institution entered into FDIC receivership
- This creates concerns for investors as to the enforceability of their security interests over the underlying asset pool in these circumstances

FDIC Proposed Securitisation Safe Harbour (cont.)

- In order to provide some comfort to investors, FDIC has provided a temporary safe harbour from FDIC seizure of securitised assets, which expires 30 September 2010, unless extended. Any securitisation completed before then is grandfathered permanently and the underlying securitised assets are immune from FDIC seizure
- FDIC is seeking to introduce a permanent safe harbour so long as banks and financial institutions comply with certain conditions, such as:
 - a 5% credit risk retention
 - disclosure of fees paid to originating bankers, servicers and credit rating agencies
 - partially deferred compensation for credit rating agencies on RMBS transactions and mandatory loan-level disclosure consistent with the amended Regulation AB

Hiring Incentives to Restore Employment Act (HIRE)

- HIRE, which incorporates the Foreign Account Tax Compliance Act (FATCA), imposes a new 30% withholding tax on US source payments of interest received by non-US entities, such as offshore securitisation vehicles, if those entities are not able to identify their US noteholders

IOSCO ABS Disclosure Principles

- International Organisation of Securities Commissions in April 2010 published report on disclosure principles for public offerings and listings of asset backed securities
- Follows on from previous reports on International Debt Disclosure Principles and International Equity Disclosure Standards
- Used as a starting point the Debt Principles
- Objective of ABS Principles “to enhance investor protection by facilitating a better understanding of the issues that should be considered by regulators when developing or reviewing their disclosure regimes for ABS”

IOSCO ABS Disclosure Principles (cont.)

- Scope of the ABS Principles is “those securities that are primarily serviced by the cash flows of a discrete pool of receivables or other financial assets that by their terms convert into cash within a finite period of time”
- Includes RMBS and CMBS
- Does not include CDOs or securities backed by asset pools that are actively managed
- Does not include covered bonds
- Aim of developing the overriding principle that a disclosure document should contain all information that would be material to an investor’s decision and that is necessary for full and fair disclosure
- Sets out 19 general categories of information to be included in any ABS disclosure document

IOSCO ABS Disclosure Principles (cont.)

- I. Parties responsible for the document
- II. Identity of parties involved in the transaction
- III. Functions and responsibilities of significant parties involved in the transaction
 - includes Sponsor (the entity arranging the securitisation by selling/transferring assets to the issuer) and its business and securitisation experience and (if applicable) similar information in relation to any intermediate depositor entity created by the Sponsor for some jurisdictions to intermediate between it and the issuer
 - in relation to the issuer, as well as general information about it, details of its permissible activities/restrictions, its directors/senior management, the manner of the sale/transfer of assets to it and details of any security interests over the asset pool and the extent to which bankruptcy or similar events can occur in respect of the issuer

IOSCO ABS Disclosure Principles (cont.)

- In relation to the servicer, a description of its function and role, its relevant experience, the material terms of the servicing arrangements, the circumstances in which a back-up servicer would assume the servicing role and the extent to which the servicer may modify the terms of the assets backing the ABS
- in relation to a trustee, the trustee's background and responsibilities, limitations on its liability and the circumstances in which it could resign or be removed
- in relation to an originator (if different from the sponsor), details of its form of organisation, its main business activities, its origination experience and policies and underwriting criteria

IOSCO ABS Disclosure Principles (cont.)

IV. Static pool information

- information as to how different pools of assets, originated at different intervals, are performing over time
- to include information regarding delinquencies, cumulative losses and prepayments for prior securitised pools of the sponsor for the same type of asset with similar characteristics for the past several years
- different types of information for difference structures, such as revolving asset master trusts (e.g. for credit card receivables)

V. Pool Assets

- general information regarding pool asset types and selection criteria
- pool characteristics
- delinquency and loss information
- sources of pool cash flow
- representations, warranties and repurchase obligations regarding pool assets
- claims on pool assets
- revolving periods, prefunding accounts and other changes to the asset pool

IOSCO ABS Disclosure Principles (cont.)

- VI. Significant obligors of pool assets
 - information about their organisational form, business, history, any recent adverse changes
 - financial information
- VII. Description of the Asset Backed Securities
 - general information regarding the types/categories of securities offered, including as to amortisation, subordination
 - credit ratings, including whether the sale of any class of security is conditional on a certain credit rating and if so details of that rating and the rating agency to be used
- VIII. Structure of the transaction
 - flow of funds
 - distribution frequency and cash maintenance
 - fees and expenses
 - excess cash flow
 - master trusts
 - optional/mandatory redemption or termination
 - prepayment, maturity and yield considerations

IOSCO ABS Disclosure Principles (cont.)

- IX. Credit enhancement and other support
 - descriptive information of any external credit enhancement designed to ensure the ABS or the pool assets will pay in accordance with their terms
 - information regarding significant enhancement providers
- X. Derivative instruments
 - descriptive information about the counterparty and its business and the material terms of the derivative instrument
 - financial information about the derivative counterparty
- XI. Risk Factors
 - relating to the issuer
 - relating to the classes of ABS being offered
 - relating to the pool of assets/ownership rights attached to the assets

IOSCO ABS Disclosure Principles (cont.)

XII. Markets

- identity of relevant exchanges/markets on which the ABS are to be traded
- details of entities providing liquidity/market making

XIII. Information about the public offering

- the manner in which the public offering will be conducted including offer period and amount of the issue

XIV. Taxation

- tax treatment of the ABS transaction under applicable income tax laws
- income tax consequences of purchasing, owning or selling the ABS

XV. Legal proceedings

- details of any material legal proceedings against significant parties to the transaction

IOSCO ABS Disclosure Principles (cont.)

XVI. Reports

- description of the reports required by the transaction documents
- details of which entities reports need to be filed with and whether reports will be available on a website

XVII. Affiliations/Relationships/Related Transactions

- affiliations among participants in the securitisation transaction
- relationships outside the ordinary course of business among participants
- relationships related to the securitisation transaction/pool assets

XVIII. Interests of Experts and Counsel

- direct/indirect economic interests of experts/counsel in the issuer/arranger/sponsor/depositor/their affiliates or which otherwise creates a conflict of interest in their position of counsel/expert

XIX. Additional Information

- material contracts entered into by the issuer/its affiliates
- statement by expert – where the disclosure document indicates that a report/statement in that document can be attributed to an expert, details of that expert's identity and qualifications

Recent Rating Agency Developments - Rule 17g5

- Rule 17g5 is part of rules adopted in November 2009 by the SEC
- Requires paid NRSROs to set up a password-protected “Ratings in Process” website containing a list of:
 - all structured finance transactions for which it is in the process of determining an initial rating
 - the website address where the issuer, sponsor or underwriter of the structured finance product provides certain required information
- The NRSRO must provide free and unlimited access to that website to any other NRSRO that provides relevant certification
- Rule came into force on 2 June 2010
- Non U.S. issuers selling securities to non U.S. investors are exempt from the requirements for six months

Recent Rating Agency Developments - Rule 17g5 (cont.)

- The rule applies to all engagements after 2 June 2010 and pre June 2 engagements if the necessary information to begin the rating process was delivered after that date
- The issuer must post on its website all information the issuer provides to the paid NRSRO for the purpose of determining the initial rating and undertaking rating surveillance
- Information must be posted at the same time the information is provided to the paid NRSRO
- Eligible NRSROs who view websites must not access any issuer websites more than 10 times in any calendar year without rating and maintain credit ratings for at least 10% of the issued securities for which it accessed information
- Annual certificates must be provided to the SEC by the NRSRO stating access is solely for the purpose of determining and maintaining credit ratings and it has and will comply with its obligations under the Rule
- EU version of Rule 17g5 proposed by EC Commission on 2 June 2010 is very similar to the SEC requirements

Discussion Points

- What current market activity is there?
- What are the prospects for the securitisation market over the coming months and years?
- Will CDOs and synthetic CDOs return in a meaningful way?
- What effect are the regulatory changes outlined earlier likely to have on the market?
- Covered bonds v rmbs transactions
- Effect of government schemes and their phasing out

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