

# Reforms Affecting Securitization

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# Reforms Affecting Securitization

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- Dodd-Frank Reform Act
- Accounting – FAS 167/167
- Bank Capital Rule
- Rule 17g-5
- Rule 436(g) – D-F § 939G
- Reg AB II
- FDIC Sale Rule
- Basel III
- Basel 2.5
- CRD Article 122a
- Hire Act

# Dodd-Frank Reform Act

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- Risk Retention – D-F § 941
  - 5% of credit risk
    - One year from enactment for residential mortgage assets
    - Two years from enactment for all other assets
    - Applies to both public and *private* ABS transactions
  - Vertical slice? Permissible form? TBD
  - Allocated between securitizer and originator TBD
  - Can be lowered based on underwriting standards TBD
  - “qualified residential mortgages” TBD
  - No hedging or transfer of risk
  - Retention period? TBD
  - October 19, 2010 FRB released a report on risk retention

# Dodd-Frank Reform Act (cont.)

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- Disclosure – D-F § 942
  - Asset level disclosure **TBD**
  - Compensation of broker and originator
  - Amount of risk retention of securitizer and originator **TBD**
  - D-F § 943 -- Fulfilled and requested repurchases across all trusts aggregated by originator
    - Rule 15Ga-1 and Rule 17g-7
  - D-F § 945 -- Due diligence on assets must be performed and disclosed
    - Rule 193
- Investment Advisor Exemption – D-F § 403
  - No longer an exemption from registration for fewer than 15 clients
  - “foreign private advisers”
    - No US place of business
    - Fewer than 15 clients in private funds (3(c)(1) or 3(c)(7) entities)
    - Less than \$25,000,000 in US client assets under management

# Dodd-Frank Reform Act (cont.)

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- Derivatives – D-F § 721 et seq
  - 5 year transition period
  - Push out rule: No Federal assistance to any “swaps entity”
  - Certain exemptions for banks, including hedging own activities, including currency, interest rate, precious metals
  - Compliance with Volker Rule
- No conflicts of interest for one year – D-F § 621
  - No u/w, sponsor, initial purchaser or any affiliate of any ABS will engage in any transaction that will result in a material conflict of interest with any investor
    - Eliminates CDS vehicles
    - Eliminates credit linked note vehicles that protected bank’s assets if bank is also the u/w
    - Can u/w do simple interest rate swaps?
    - Can u/w retain subordinated notes? Senior notes?

# Dodd-Frank Reform Act (cont.)

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- Volker Rule – D-F § 619
  - No banking entity shall acquire any equity, partnership or ownership interest in any hedge fund or private equity fund (*any 3(c)(1) or 3(c)(7) entity*)
  - No more than 3% of the equity of the entity after one year [note 5% interest NOT allowed]
    - In the aggregate  $\leq 3\%$  of Tier 1 capital
    - Investment shall be deducted from capital and the amount the deduction shall be *commensurate* with the amount of leverage of the hedge fund or private equity fund
  - Can bank keep a 1st loss piece in a 3(c)(1) or 3(c)(7) securitization?
  - No proprietary trading
    - No TRR book or CDS book
  - Foreign bank exemption
    - No U.S. investors
    - Investment “outside” the U.S.

# Dodd-Frank Reform Act (cont.)

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- Rating agencies liable for their statements – D-F § 933
  - for “knowing or reckless failure” to conduct a reasonable investigation or obtain reasonable verification
- Rating agencies subject to “expert” liability – D-F § 939G
  - Abrogation of Rule 436(g)
  - See Ford Motor Credit Company Nov. 23, 2010 and Jul. 22, 2010

# Dodd-Frank Reform Act (cont.)

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- Some of the questions created
  - Is a mutual fund or a money market fund an “asset backed security”?
  - Is a guarantee or a letter of credit a “swap agreement”? And is the guarantor or issuing bank a “swap entity”?
  - Does an interest satisfying the requirements for risk retention violate the conflict of interest provision of §621?
  - Can a bank hold a first loss position in a 3(c)(1) or 3(c)(7) securitization?

# Accounting – FAS 166/167

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- Much harder to obtain “sale” treatment of a securitization
  - Must be legally isolated from the transferor and its consolidated affiliates
    - Ignore “bankruptcy remote” subsidiaries
    - transferor must surrender control
    - Transferees must have the right to pledge or exchange the assets
- A variable interest holder must consolidate a variable interest entity if it has a “controlling financial interest” – an interest will be a “controlling financial interest” if
  - Activities of the holder most significantly impact the entity’s economic performance
  - The holder has the obligation to absorb losses the could potentially be significant or the right to obtain benefits that could potentially be significant to the entity
    - Unilateral “kick-out” rights held by single party can prevent consolidation
- Less “gain on sale” accounting

# Bank Capital Rule

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- Full capital against securitizations consolidated under FAS 166/167
  - No adjustment for risk transfer
- Leverage ratio: 15:1
- So many securitizations will be capital constrained and leverage constrained

# Rule 17g-5

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- Issuer, sponsor or underwriter must post all rating agency material on a password protected internet website
  - Material is available to any NRSRO that can make required certifications
  - Some uncertainty around “site visits” and meetings
- Proprietary data and procedures can become “public”
- Issuer can be exposed to “punitive” ratings

## Rule 436(g) – D-F § 939G

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- Eliminates exemption of rating agencies from status as “experts” in prospectuses
- Consent from rating agency required for disclosure of a rating
- Rating agency is exposed to Section 11 liability
- Passage of Dodd-Frank froze the securitization market
  - Rating agencies would not issue ratings that would be disclosed in a prospectus
- In response, the SEC issued a no-action letter on the Reg AB requirement (*Items 1103(a)(9) and 1120*) to disclose ratings in a prospectus
  - Ford Motor Credit Company LLC available July 22, 2010
  - Extended indefinitely on November 23, 2010

# Reg AB II

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- Extensive loan level data disclosure **TBD**
- File a computer program of the cash flow waterfall **TBD**
- Reg AB extended to cover 144A and Reg D offerings **TBD**
  - Same disclosure as S-1 offering
  - Departure from “sophisticated purchaser” paradigm for private placements
- Shelf offerings require:
  - a preliminary prospectus be available 5 days prior to pricing **TBD**
  - CEO certification of assets being “sufficient to pay” offered securities **TBD**
  - Quarterly 3<sup>rd</sup> party opinion that assets not repurchased for breach of reps in fact were not in breach **TBD**
  - 5% risk retention; allocated among originator and sponsor **TBD**

# FDIC Sale Rule 12 CFR 360.6

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- Promulgated because of adoption of FAS 166/167
- Provides
  - A safe harbor for sale treatment of transfers of assets that qualify as a sale under FAS 166/167 for all but legal isolation requirement, or
  - Relief from the 90-day automatic stay for securitizations that fail to qualify as sales under FAS 166/167
- To qualify:
  - 5% risk retention [representative sample of assets ok]; no hedging
  - Loan level disclosure and periodic reports
  - Disclose reps and warranties regarding assets and remedies for breach
  - No synthetic or unfunded securitizations
  - Payments may not be contingent on external market or credit events
  - If RMBS, no more than 6 tranches
  - If RMBS, loans originated in accordance with all supervisory guidance
  - If RMBS, 5% cash reserve for one year to repurchase loans in breach of reps
  - If RMBS, no external credit support or guarantees
    - Exception for FNMA, FNMA and FHLMC guarantees

# Basel III

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- Higher capital requirements
  - Minimum common equity from 2% to 4.5%
  - Some instruments no longer count as capital
  - More conservative risk weightings of assets
  - Equity and other capital must be 8% (same percentage as today)
  - Capital conservation buffer of 2.5%
- Leverage ratio **TBD**
- Liquidity coverage ratio **TBD**
  - Liquid assets sufficient for 30 days cash outflows
- Net stable funding ratio **TBD**
  - Illiquid assets to be funded by equity, long term debt (> 1 year) and 'stable' deposits

# Basel 2.5

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- Higher capital requirements for securitizations

# CRD Article 122a

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- Bank investors must obtain sufficient information from issuer to ascertain the exposure of their investment
  - Failure to do so could result in a deduction from capital of 100% of the investment
  - EU bank sponsors are required to provide investors with access to all relevant data
- Requires 5% risk retention by any of originator, sponsor or original lender of the securitization
  - Sponsor must be a credit institution to satisfy the risk retention rules
  - Member States may require more than 5%
  - No hedging of the risk
  - Form of retained interest must be in the form of one of four options
  - Very narrow exemptions

# Hire Act

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- Hiring Incentives to Restore Employment Act
- Repeal the TEFRA C and TEFRA D exception for bearer bonds issued by U.S. issuers to non-U.S. persons
- Repeals the exception to a denial of interest deduction for interest paid on such bearer bonds
- Interest paid on such bearer bonds would no longer qualify for treatment as portfolio interest – thus subject to a 30% withholding tax
- U.S. issuers will need to eliminate programs issuing in bearer form and issue in registered form
- Some foreign investors may be unwilling to provide certification of non-U.S. beneficial ownership (Form W-8BEN)

# Credit Rating Developments

March 9, 2011  
David Lynn

# Credit Ratings After Dodd-Frank

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- Repeal of Rule 436(g)
- Removal of exemption from Regulation FD
- Removal of credit ratings from rules
- SEC oversight of credit rating agencies
  - Liability reforms
  - Required disclosures
  - Prohibited activities
  - Governance
  - Conflicts of interest

# Repeal of Rule 436(g)

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- Prior to repeal, Rule 436(g) exempted NRSROs from the requirement to provide a consent if ratings were included in a Securities Act registration statement or prospectus
- Following the repeal, the SEC Staff provided interpretive guidance on situations where consents of credit rating agencies would not be required, such as when:
  - Ratings are included in FWP's that comply with Securities Act Rule 433 and in term sheets or press releases that comply with Securities Act Rule 134
  - Disclosure-related rating information is included in periodic reports (for example, disclosure relating to a change in a credit rating, liquidity of the issuer, or the terms of agreements that refer to credit ratings)
  - Information is included or incorporated by reference in a registration statement on Form S-3 or F-3 that was declared effective prior to July 22, 2010
- Separate relief was provided for issuers of asset-backed securities

# Removal from Regulation FD

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- On September 29, 2010, the SEC adopted final rules amending Regulation FD to eliminate an exemption for credit rating agencies
- The amendments to Regulation FD were made pursuant to Section 939B, and became effective on October 4, 2010
- As a practical matter, there was little impact on communications between issuers and credit rating agencies, because most credit rating agencies are already outside of the scope of Regulation FD because they are no longer considered investment advisers

# Removal of Ratings

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- Section 939A of the Dodd-Frank Act directs all federal agencies to review, no later than one year after enactment, any regulation that requires the use of an assessment of credit-worthiness of a security or money market instrument and any references to or requirements in regulations regarding credit ratings.
- The agencies are also required under the Dodd-Frank Act to remove references or requirements of reliance on credit ratings and to substitute an alternative standard of credit-worthiness.

# Removal of Ratings

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- The SEC has proposed amendments to the eligibility requirements for registration statements on Form S-3 and Form F-3, as well as other amendments to rule and form requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934 to remove any reference to credit ratings issued by NRSROs (similar to amendments proposed in 2008)
- The SEC has proposed to revise General Instruction I.B.2. of Form S-3 and Form F-3 to provide that an offering of non-convertible securities is eligible to be registered on Form S-3 or Form F-3 if the issuer has issued at least \$1 billion of non-convertible securities in transactions registered under the Securities Act, other than equity securities, for cash during the past three years (as measured from a date within 60 days of the filing of the registration statement) and satisfies the other relevant requirements of Form S-3 or Form F-3, as applicable.

# SEC Oversight

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- Planned SEC rulemaking for April – July 2011 to address substantive oversight provisions of Section 932, 936 and 938.
  - Required disclosures
  - Prohibited activities
  - Governance
  - Conflicts of interest
- The SEC's Office of Credit Ratings has not been created and staffed due to budgetary considerations.