Dodd-Frank & Securitization: The Basics You Need to Know

By Heath Tarbert and Nancy Lynch of Weil, Gotshal & Manges

On July 21, 2010, President **Obama** signed into law a package of financial regulatory reforms unparalleled in scope and depth since the New Deal. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act") is a sweeping reaction to perceived regulatory failings revealed by the most severe financial crisis since the Great Depression. The securitization markets are among those sectors targeted by the 2,300-page legislation. In particular, the securitization provisions of Dodd-Frank increase exposure for originators and securitizers by requiring them to retain an economic interest in the credit risk of various kinds of ABS. The Act also authorizes the SEC to promulgate new disclosure requirements for ABS issuers. Finally, the SEC has announced that it will create three new offices within its Division of Corporation Finance to focus on ABS and other structured products, securities offering trends, and large financial institutions.

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For the past few decades, securitization has played a beneficial role in consumer and business finance. The advent of the securitization process significantly reduced financial institutions' risk exposure, which has facilitated extensive market growth and provided millions of consumers and businesses with access to financing that they may have not otherwise received. The financial crisis, however, has severely impaired the securitization markets, and certain aspects of those markets have been criticized by some as playing a role in the meltdown. Specifically, critics have alleged that the incentives of both mortgage originators and underwriters of securities backed by those mortgages have not been fully aligned with the incentives of investors who eventually purchased the securities. Underwriters and originators have been largely compensated on the basis of the initial sale of the securitized products and the underlying assets, respectively. But the benefits (and burdens) accrue to investors only with the longer-term performance of those assets. Consequently, a central focus of Dodd-Frank is an attempt to correct this perceived imbalance.

"Skin-in-the-Game" Requirement

Congress has accordingly directed federal bank regulators and the SEC jointly to prescribe rules requiring securitizers of ABS to retain an economic interest—"skin in the game"—in the credit risk (generally 5%) of any asset transferred, sold, or conveyed to a third party through the issuance of an ABS. That economic interest may not be hedged or transferred to a third party. The Act defines an ABS as a fixed-income or other security collateralized by a self-liquidating financial asset (i.e., a loan, lease, mortgage, or receivable) that allows the holder of the security to receive payments depending primarily on cash flow from the asset. Congress has made the definition broad enough to cover collateralized debt and mortgage obligations.

As with most of the bright-line rules in Dodd-Frank, the 5% risk-retention requirement has some exceptions. Securitizers will not be required to retain any portion of the credit risk for an asset that is transferred, sold, or conveyed if all the assets that collateralize the ABS are "qualified residential mortgages." Congress has directed federal bank regulators and the SEC, together with the Department of Housing and Urban Development and the Federal Housing Finance Agency, jointly to define the category of "qualified residential mortgages" after considering certain product and underwriting features that have historically been associated with lower default risks. Most likely, the category will include a large portion of those loans originated by Fannie Mae and Freddie Mac.

In addition, the Act directs the regulators to establish various asset classes with different credit risk retention rates, including ABS backed by automobile loans, commercial mortgages, home mortgages, and any other asset class deemed appropriate. For each asset class, the relevant

regulators will establish underwriting standards specifying the terms, conditions, and characteristics of a loan that indicate a reduced credit risk. Most important, the regulations may provide that if an originator meets these reduced credit risk standards, then the securitizer may retain less than 5% of the credit risk. In this respect, these rules may provide the equivalent to an additional exemption.

Dodd-Frank also contemplates the establishment of total or partial exemptions from risk retention for the following:

- any loan or other financial asset made, insured, guaranteed, or purchased by any institution that is subject to the Farm Credit Administration
- any securitization of an asset issued or guaranteed by the United States or a US agency (except Fannie Mae and Freddie Mac)
- certain state and municipal securitizations of assets (related to the cases above)

The required risk-retention amount may also be allocated between an originator and a securitizer as deemed appropriate by the regulators.

Supplemental Disclosure Requirements

In addition to the risk-retention requirement, Dodd-Frank requires more disclosure in the securitization process. Congress has directed the SEC to adopt regulations requiring ABS issuers to disclose—for each tranche or class of security—information regarding the specific assets backing that security. To enable investors to compare data across securities in similar types of asset classes, the SEC is required to establish standardized disclosure formats. At a minimum, the SEC rules must require ABS issuers to disclose asset-level or loan-level data necessary for investors independently to perform due diligence, including:

- the identity of the loan broker or originator
- the extent and nature of the broker's or originator's compensation the amount of risk retained by the securitizer and the originator

The Act directs the SEC to promulgate regulations regarding the use of representations and warranties in the ABS market to require any securitizer to disclose fulfilled and unfulfilled repurchase requests across all the securitizer's securitizations, such that investors may be able to identify originators with underwriting deficiencies. Dodd-Frank also places a restriction on transactions that would involve a material conflict of interest that arises from the sale of an ABS for one year after the date of the first closing, unless the activity is in connection with the specific transaction and (i) risk mitigating hedging activities, (ii) made pursuant to purchases or sales to provide liquidity for an ABS, and (iii) bona fide market making in the ABS. Finally, the SEC is required to issue rules relating to the registration statement that ABS issuers are required to file, which will require the issuer to perform a due diligence analysis of the assets underlying the ABS and disclose the nature of that analysis to potential investors. With these provisions, Congress seeks to ensure that investors will be provided with sufficient disclosures to make an informed decision regarding an ABS investment.

In order to enhance its disclosure review and policy operations, the SEC recently announced that it will create three new offices in its Division of Corporation Finance. One office will focus on disclosure reviews and policymaking for ABS and other structured finance products, and another will review new securities products and capital market trends, and develop recommendations for changes to enhance investor protection in securities offerings. A third office will handle disclosure review, allowing the SEC to increase the number of large financial services companies subject to review.

Potential Impact of Dodd-Frank

Regulators have 270 days from the passage of Dodd-Frank (so approximately until April 15, 2011) to issue the final regulations. The regulations become effective with respect to residential mortgage ABS one year after they are published, and with respect to all other ABS two years after they are published. Until regulators release their proposed rules, however, it is difficult to predict how Dodd-Frank will impact the securitization process. One major issue to watch is how the three different proposals to rein in issuers of ABS—one from the FDIC, one from the SEC ("Reg AB II"), and a joint rule by several regulators required under Dodd-Frank—are synthesized. Currently, all three proposals essentially do the same thing—strengthen disclosure and require issuers to retain a percentage of the credit risk from ABS—but each proposal also has unique features. Unless these various measures are carefully coordinated among the relevant regulators, the resultant overlapping rules are likely to cause further confusion and uncertainty.

Nevertheless, one thing is quite certain: Dodd-Frank will increase the compliance burdens on those participating in the securitization market. The key question is whether regulators are up to the task of promulgating rules that implement congressional intent, but—at the same time—enable the securitization markets to provide sufficient consumer and commercial credit necessary for an economic recovery.

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