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Risk Retention: Throwing the Baby Out with The Bath Water

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There is significant, ongoing debate in Congress, as well as among the financial industry's regulators, as to the direction and scope of financial reform measures designed to address the problems that were perceived to be the cause of the current economic crisis. Some form of risk retention in any final legislation and rules is to be expected and perhaps is inevitable. But, it is important to understand at this still formative stage of the legislative process that the public outcry driving financial reform may unwittingly create risk retention levels in securitization transactions that will ultimately affect main street's credit costs and severely limit access to credit.

The key, we believe, is to resist the temptation to adopt broad-based reforms that do not really address the underlying causes of the global financial meltdown yet, in the process, harm a market that significantly contributed to the growth of our economy over the last few decades. For instance, an exclusion from whatever rules are adopted could be carved out for various aspects of the commercial loan

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industry. Also, risk retention might not be applied where investment sponsors are required to be more transparent about the risks or conflicts involved in their products.

Perhaps a brief summary on how we got to where we are — and how we might be able to avoid a similar situation in the future — is worthwhile.

Before the subprime mortgage crisis developed in July 2007, consumer credit and corporate leverage availability were at record levels. The availability of mortgage loans to homeowners was not a result of the misplaced generosity of mortgage lenders willing to loan money at low interest rates with little or no down payment. Similarly, the ability of businesses to obtain inexpensive money with loose repayment terms and limited contractual protections was not necessarily due to the sterling credit histories and performances of the businesses receiving such credit. Rather, the high level of credit availability was driven, to a large extent, by sophisticated investors who were willing to take the risks of the related consumer and corporate loans off of the balance sheets of banks and finance companies that originated such loans and that then sold them through rated securitization transactions. With less risk (in theory, as it turned out) on bank and finance company balance sheets, and the ability to easily transfer the related credit risk, banks and finance companies were able to extend substantially greater amounts of credit at lower rates.

The growth and efficiency of the securitization market over the last 30

years resulted in financial institutions moving away from the "loan and hold" business model. No longer were financial institutions content with loaning money and waiting for the borrower to pay interest and principal over the life of a loan, as fees became a larger component of bank and finance company profits and growth. Under the securitization model, yield could be generated from, among other things, the origination and sale of the mortgages and other consumer and commercial loans, the structuring and underwriting fees associated with the securities backed by such loans, the derivative/hedging trades relating to the transactions as well as fees relating to the managing of the securitized financial assets.

Securitization has had a tremendous impact on credit availability. It has helped fuel the growth of banks and finance companies and corporate profits as well as helped increase home values and the availability of consumer and corporate credit generally. The securitization market has been vital to the growth of the world economy and is widely considered to be a linchpin for the sustainability of that growth. As a result of recent financial and economic developments, securitization and its impact, or perceived impact, as the creator of bank and investor losses has made this financing technique a particular focus of Congress and other financial regulators. The perceived role of securitization and the sale of asset-backed and mortgage-backed securities (collectively, "ABS") as a precipitator of the recent financial

crisis has resulted in concerns regarding the securitization market generally. One area of particular focus has been “risk retention” (colloquially referred to as “skin in the game”) whereby sponsors of securitization transactions would be required to retain a certain portion of the credit risk associated with the assets being securitized in order to better align investors’ and originators’ interests. In effect, risk retention is a subset of the traditional “loan and hold” model.

RECENT CONGRESSIONAL AND REGULATORY ‘SKIN IN THE GAME’ PROPOSALS

There are presently no “risk retention” requirements in the securitization markets, but there are currently four such proposals in various contexts being considered by various U.S. regulatory and legislative bodies. A primary objective under each proposal is to align the interests of sponsors/securitizers of securitized products with those of investors. In late 2009, both the House and the Senate proposed “financial regulatory reform” legislation that includes mandatory “risk retention” standards intended to address concerns in the securitization markets. In its current form, the Senate legislation requires a “securitizer” (the sponsor of a securitization) or “originator” (one who transfers assets to a securitizer) of a securitized portfolio of financial assets to retain, on an un-hedged basis, at least 5% of the credit risk associated with each pool of financial assets. The House legislation requires that any “creditor” that makes a loan retain, on an un-hedged basis, an economic interest in at least 5% of each loan that such creditor transfers, including for purposes of securitizing a pool of financial assets.

The Federal Deposit Insurance Corporation (“FDIC”) also issued proposed rules that would require a bank sponsoring a securitization to retain at least 5% of the un-hedged credit risk of the assets transferred to the securitization entity. The retained risk would be required to be either in the form of an interest in each

tranche of the ABS or in a representative sample of the transferred assets equal to at least 5% of the principal amount of the assets transferred.

More recently, in April 2010, the Securities and Exchange Commission (“SEC”) proposed new rules to regulate the offerings of ABS. Not only do these proposed rules dramatically expand the scope of regulation of securitization through increased disclosure, but they also look to impose on securitization sponsors seeking “shelf registration” of an ABS a mandate to acquire and maintain on an ongoing basis a 5% un-hedged position in each tranche of the securitized pool (*i.e.*, a vertical slice of the deal) of such ABS. The SEC believes that risk retention requirements for shelf eligibility distinguish the quality of assets supporting the ABS that are of a higher quality and character “while avoiding the possibility of undue reliance on ratings.” It should be noted that sponsors may still offer securities publicly (or privately) without risk retention (but with additional prescribed disclosures); these offerings would not be eligible for delayed shelf registration and would, in the case of a public offering, require a substantially longer time period to bring to the market. The proposed additional disclosures would also be applicable to private transactions under both Rule 144A market and Regulation D, if the investors request such information.

HOW COULD RISK RETENTION AFFECT SECURITIZATION?

Mandatory risk retention will likely require financial institutions to hold more equity against the required retained securitization tranches. The corresponding charges for bank regulatory capital purposes will probably weigh on the consumers’ cost of funds, as it is reasonable to believe that those charges will ultimately be passed through, in one form or another, to borrowers. Moreover, any increase in interest rates is likely to drive home prices down due to the decreased purchasing power of home

buyers. As has been experienced during the current economic crises, sustained low home prices are likely to continue to have adverse effects on economic recovery. Only the best capitalized financial institutions will have sufficient capital to hold the required retention amounts and be able to access the securitization market as a securitization participant. Additionally, the cost of capital related to the retention requirement will ultimately limit access to the securitization market for startup/entrepreneurial finance companies that have traditionally provided financing to the middle markets.

Risk retention in the context of securitized commercial loan funds (or CLOs), which hold a significant percentage of the outstanding commercial loans today, could significantly impair credit availability for many U.S. businesses. Existing CLOs are one of the primary buyers of loans in the secondary market but cannot hold significant portions of any one loan due to contractual limitations imposed by investors and rating agencies. Additionally, existing CLOs only have limited amounts of funding availability through their available reinvestment periods. Because CLO issuance has been negligible during the past two and one-half years and reinvestment amounts available under existing CLOs are limited, risk retention minimums applied to any CLO “securitizer” (*e.g.*, the manager or sponsor) would further hamper the formation of new CLOs available to buy loans. Many CLO managers and sponsors are simply not in the position to make such large investments in the CLO tranches as required by the proposed risk retention rules. Applying risk retention standards to commercial loans of this type could significantly limit the number of CLO lenders available to make and participate in newly originated commercial loans and provide financing for the estimated trillions in dollars of commercial loans that are scheduled to mature between 2012 and 2014. It is unclear in, for example, the CLO context, which entity would be considered the “sponsor” of the transaction. It is

possible it could be the manager (who does not typically own any of the loans) or the underwriter/placement agent (who may or may not have an interest in a portion of the loans). The SEC's proposing release acknowledges that originators of loans may not have the resources to retain risks.

It is not necessarily a negative that certain businesses and consumers who previously had access to "cheap money" with loose terms will no longer have access on as favorable terms. Moreover, risk retention will slow transaction pace, which will provide professionals greater time to more appropriately disclose transactional risks (and for investors to understand them), and avoid the sloppiness that comes from an overheated market. However, careful consideration should be given so as not to shift the pendulum too far in the other direction. More extensive due diligence with respect to both structure and assets in the subprime securitization and CDO market investors should have occurred — ultimately, investors must do their job and not rely solely on ratings as they did when the securitization market was frothy. The reality is that many sponsors of securitizations (or their affiliates) have historically retained a portion of the credit risk of the securitized pool, either through retention of the first loss position or the more senior tranches that do not yield sufficient returns for investors.

Another possible effect of mandatory risk retention is the impact on financial reporting. Recently issued Statements of Financial Accounting Standards Nos. 166 and 167 modified the accounting treatment for transfers of financial assets and the consolidation of variable interest entities ("VIEs") — most securitization vehicles are VIEs. While the risk retention proposals are not likely to have an impact on the legal isolation analysis necessary to obtain "true sale" legal opinion comfort, they will require a more thorough analysis by outside accountants and management when analyzing whether the sponsor of a

securitization has a controlling financial interest in a VIE through the retention of economic risks and benefits.

CONCLUSION

Financial institutions as well as consumers require and benefit from the liquidity and risk transfer mechanisms that are available from an efficient securitization market. It is better for the financial system as a whole to permit the diversification that securitization provides which ultimately reduces systemic risk inherent in concentrated loan holdings as well as provides investors alternative investment opportunities. Without an efficient securitization market, access to capital for consumers and businesses will decline while the cost of available capital will rise. Imposing further restrictions on a primary component of capital availability and liquidity could provide a damaging blow to the slowly stabilizing economy.

One potential solution as it relates to commercial loans is to have loan funds and loan managers expressly excluded from the risk retention proposals. CLOs were designed, in part, to allow a diverse group of sophisticated investors to obtain exposure to the commercial loan market. Requiring risk retention in the context of the commercial loan market would make CLOs, in their current form, unpalatable for all but the largest financial institutions and loan managers and would inhibit the very risk diversification that syndicated loan transactions were designed to accomplish.

Another solution would be to not mandate risk retention, but instead require sponsors to prominently and specifically disclose the amount and form of the risks that are retained as well as disclose conflicts and other related facts. Indeed, the SEC acknowledges this approach as a viable alternative in its discussion of risk retention and shelf eligibility standards. If risk retention simply becomes a cost of securitizing, will a sponsor's forced risk retention really mean that the quality and

characteristics of a pool of assets are of higher quality? The sponsor would still be selling up to 95% of the credit risk.

ABS investors are characteristically sophisticated institutions and, when appropriately engaged, should be able to understand the risks of the sponsor not having any "skin in the game." With the proper disclosure, the investors can decide which transactions are worthy of their dollars.

While the legislative and regulatory efforts are only proposals at this stage, the intense pressure on legislators and regulators to fix the problems that were perceived to be the cause of the current economic crises will almost certainly result in the adoption of some form of risk retention in the final legislation and rules. Who is covered and what exceptions there will be to those rules will be key issues. Ultimately, the CDOs and subprime transactions that should never have been done (but were done solely on a ratings-based model founded on misplaced assumptions) and purchased without appropriate investor diligence of available information created the financial contagion. Ironically, the resulting public outcry may create risk retention levels that will ultimately affect main street's credit costs and credit availability.