



Obama Administration Proposes Comprehensive Reform of Financial Regulation: Strengthening Supervision of Securitization Markets

On June 17, 2009, the Obama administration released its long-anticipated proposal for financial regulatory reform (the “Proposal”). Included in the Proposal are measures intended to strengthen the regulation of core markets and market infrastructure, and to increase transparency with respect to the distribution of risks associated with certain, particularly newer, financial instruments. To that end, the Proposal specifically addresses the need to strengthen and further regulate securitization markets.

Strengthening Supervision of Securitization Markets

To address what the Obama administration calls a “breakdown” of market discipline related to the securitization process, the Proposal details the following objectives:

- (1) the issuance of regulations by federal banking agencies requiring an originator or a sponsor of a securitization to retain an economic interest in a material portion (*i.e.*, five percent) of the credit risk of securitized exposures;
- (2) the promulgation of regulations designed to align compensation of market participants with longer term performance of underlying, securitized loans;
- (3) the increase of transparency and standardization with respect to securitization markets and the clear establishment of the SEC’s related authority to require robust reporting by issuers of asset-backed securities;
- (4) the strengthening of the SEC’s regulation of credit rating agencies, including with respect to managing and disclosing conflicts of interest, differentiating between structured and other products, and generally promoting the integrity of the ratings process; and
- (5) the reduction of the use of credit ratings in regulatory and supervisory practices of regulators.

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1. Retention of Economic Interest by Originator/Sponsor

To address perceived inadequacy of disclosure regimes, the complexity and opaqueness of asset-backed securities structures, and weakened due diligence incentives with respect to underlying assets, the Proposal calls for the promulgation by federal banking agencies of regulations requiring loan originators or sponsors to retain five percent (5%) of the credit risk associated with any securitized exposures. The Proposal also indicates an intent to prohibit such originators or sponsors from directly or indirectly transferring or hedging the risk required to be retained. According to the Proposal, the federal banking agencies would have the authority (1) to specify the permissible forms of required risk retention (*e.g.*, retention of a first-loss position or a *pro rata* vertical slice) and the minimum duration of such retention; (2) with respect to the retention requirements, to provide exemptions, exceptions, or adjustments that are consistent with relevant notions of safety and soundness; and (3) to apply retention requirements to securitization sponsors (instead of loan originators) in order to achieve the Proposal’s intent.

The Proposal's retention requirement is directed at increasing the incentives of lenders and sponsors to consider the performance of underlying assets and to emphasize an appropriate economic tie between the originator and any asset-backed securities collateralized by the originator's loan(s) (*i.e.*, to require an originator's "skin in the game"). At least with respect to registered commercial mortgage-backed securitizations, it is noteworthy that the typical structure already includes the presence of a third-party investor in non-investment grade securities (*i.e.*, the "B-piece" or the "B-buyer"), which investor often conducts extensive credit analysis of underlying assets and holds a first-loss position. This may raise questions as to whether a B-buyer, especially one that holds long term and does not quickly sell its interests into a collateralized debt obligation (CDO) transaction, sufficiently underwrites deal risk such that adequate skin is already in the game, and as to whether true sales (with no retention) of underlying assets in that context would still offend the intent of the Proposal.

2. Alignment of Compensation With Longer Term Performance of Underlying Assets

The Proposal suggests that an increased focus on underwriting standards could be borne out of a market participant compensation standard that is linked to the long-term performance of underlying, securitized assets and not only to the production, creation, or inception of the related products. Accordingly, market participants, including brokers, originators, sponsors, underwriters, and others, would potentially be compensated over time depending upon underlying asset performance, with reductions in compensation applicable to underlying assets that fail to perform over time. In a related point, the Proposal also supports the initiative by the Financial Accounting Standards Board (FASB) to amend the Generally Accepted Accounting Principles (GAAP) to eliminate the immediate recognition of "gain on sale" by originators at the inception of a securitization; instead, the amendments would require originators to recognize income over time. In some circumstances, FASB's proposed amendments would also require that an originator's balance sheet reflect the consolidation of securitization transactions and that its financial statements reflect the related asset performance. Finally, the Proposal calls for stronger, standardized representations and warranties by sponsors with regard to origination and underwriting risks.

The Proposal does not, however, address how regulators or market participations are to appropriately administer the proposed compensation scheme if adverse factors related to long-term performance are not distinctly tied to insufficient underwriting standards but are instead, for example, caused by bad business practices of a borrower or general market conditions.

3. Transparency, Standardization, and Robust Reporting Requirements by the SEC

To strengthen ongoing efforts by the SEC to improve and standardize securitization disclosure practices by originators, underwriters, and credit rating agencies, the Proposal suggests that the SEC be given clear authority to require ongoing reporting by issuers of asset-backed securities. Generally, the Proposal demands that increased access to asset information be given to investors and credit rating agencies at the inception and over the life of a securitization so that investors may appropriately assess, among other things, credit, market, liquidity, and risk. More specifically, the Proposal's requirements include that an issuer must disclose loan-level data (broken down by loan broker or originator) and the nature of broker, originator, and sponsor compensation and risk retention. To be clear with respect to at least certain asset-backed deals, loan-level data and risk retention statistics are generally subject to disclosure under current regulatory schemes; to what extent, however, the Proposal requires further or more detailed data is not yet clear.

Of significance is that the Proposal includes a requirement, with respect to residential mortgage-backed securities, for the creation of clear and uniform standards allowing servicers to modify home mortgage loans in certain circumstances that benefit a securitization trust. The Proposal's residential loan modification provision, which is similar to recent federal legislative efforts regarding a mortgage loan safe harbor for servicers, does not yet extend to the commercial market. It is important to follow the Proposal's development with regard to its separate treatment of commercial and residential securitizations.

The Proposal also provides for expansion by the SEC and the Financial Industry Regulatory Authority (FINRA) of the Trade Reporting and Compliance Engine (TRACE), a standard, electronic trade-reporting database for corporate bonds, to include asset-backed securities.

4. Regulation of Credit Rating Agencies by the SEC

Central to the Proposal's discussion of the SEC's continued regulation of credit rating agencies is the notion that different credit ratings be used for structured products and unstructured products. The Proposal calls for further, precise disclosure by credit rating agencies with respect to credit rating criteria and related risks (*e.g.*, the likelihood of default and/or the related loss severity). It also requires disclosure of credit rating methodologies to users of credit ratings and disclosure to the SEC of any unpublished rating agency data and methodologies. The idea of differentiated credit ratings is not new; it has not gained favor thus far through previous federal legislative efforts and there already exists a

significant debate as to whether a separate credit rating structure enhances or confuses a proper understanding of credit ratings

5. Regulators' Reduction in Use of Credit Ratings

To emphasize the potential performance distinctions between structured and unstructured credit instruments with the same credit rating, and to minimize opportunities for firms to use securitization to reduce regulatory capital requirements without a

commensurate reduction in risk, the Proposal calls for risk-based regulatory capital requirements to appropriately reflect the risk of structured products, including risks associated with senior/junior tranching, re-securitizations, and securitized exposures held in highly leveraged off-balance sheet vehicles.

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