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Risk Retention in Securitization

The Financial Reform Plan that President Obama announced in June was a sweeping outline that contemplated, among other things: overhauling the financial system's regulatory framework, requiring registration of more hedge and private equity fund managers, bringing OTC derivatives onto exchanges, creating the Consumer Financial Protection Agency, creating a mechanism to wind down systemically important failing financial firms…and fixing securitization.

As we've discussed in prior VFTCs, included in the President's Plan to fix securitization was a requirement that originators of securitized loans and securitization sponsors retain a portion of the "credit risk" of those transactions. The President set his skin in the game requirement at 5% of the credit risk.

On October 27, the House Financial Services Committee and the Treasury Department released a discussion draft of proposed legislation that would implement the securitization reform proposals of the President's Financial Reform Plan. While most of the discussion draft looks like what the President had originally outlined, the proposed legislation takes a much harder line on risk retention. The Financial Services Committee has doubled down on the amount of risk retention that would be required—10% of the credit risk vs. the President's opening 5%. The 10% can be reduced (but not below 5%) if the credit underwriting of the lender and the diligence done by the securitizer comply with standards to be determined by the SEC and the banking regulators. The opposite is also true— the 10% can be increased if the SEC or banking regulators determine that the credit underwriting or diligence is not sufficient. What's more, the party required to hold the risk retention piece will not be allowed to hedge that risk away.

But the most expansive change from what was initially proposed in the President's Financial Reform Plan is in the scope of the risk retention requirement itself. The draft legislation would apply the 10% risk retention requirement not only to securitized loans—but also to all loans sold in the secondary market. And the language can be read to mean that the 10% risk retention requirement would apply independently to each secondary market transaction. Taking it to an extreme, if a loan were to be sold from the Originator to Purchaser A, who then sold to Purchaser B, who then sold to Purchaser C, … when we get to Purchaser I, has 100% of the credit risk been accounted for and we're all good? That's surely not the intent, but it's not clear from the draft legislation. Many of the terms used are not defined.

In fact, the critical term around which all this turns—"credit risk"—is not defined in either the Financial Reform Plan or in the draft legislation. It's not clear whether the term "credit risk" as used in the Plan or the draft legislation is intended to be an estimate of future credit losses expected to be incurred (which begs the question, whose estimate?) or whether it's the principal amount of the loan or something else.

But whatever "it" is, the House Financial Services Committee has decided that 5% of it is not enough. You need to hold on to 10%.

There are also unintended consequences of the risk retention proposal in its current form that could be significant. Risk retention generally runs counter to the notion of a sale—if you retain too much

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exposure to the ongoing performance of an asset that you transferred, then have you really sold it. What constitutes "too much" has been a source of tension in both the accounting and legal ranks for some time.

For a transfer to be treated as a sale for accounting purposes, the gating question of whether it is a "true sale" for legal purposes must first be addressed. If it's not a legal true sale, then it's not a sale for GAAP.

In addition to GAAP considerations, legal true sale status has its own significant implications—particularly in the context of a bankruptcy of the seller.

In virtually every securitization, a condition to get a rating on the securities and closing the deal was that a reputable law firm opine that the transfer of the assets into the issuing vehicle constituted a true sale and that, in the event of the transferor's bankruptcy, the transferred assets would be treated by the court as separate from the transferor. To deliver that opinion, the law firm would consider all the facts and circumstances surrounding the transfer. Injecting a requirement that the seller retain 10% of the credit risk of the loans being transferred will complicate the analysis for both securitizers and whole loan market participants. The risk retention may be viewed as recourse, which could lead to a conclusion that the transfer is not a legal true sale. This would be a big problem. This means that responsible lenders originating FHA and GSE eligible loans and selling them on to Wells or BofA for securitization into Ginnie/Fannie/Freddie pools are not really "selling" the loans. If the transfer from the originator is not a legal true sale, then the loans would still be part of that originator's bankruptcy estate and subject to the claims of the originator's creditors in bankruptcy. That will not enhance liquidity in the secondary market.

The discussion draft is just that—a draft. Hearings are being held and many of the questions and open items may be resolved. And maybe in those hearings somebody will point out that the likes of Countrywide, WaMu, Golden West, IndyMac, New Century, etc. held tons of retained risk on the loans they originated, and were looking for more.

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