THE NATIONAL LAW REVIEW

Treasury Recommends Changes to Post-Financial Crisis Securitization Rules

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Law Flash

- Administrative & Regulatory
- Financial Institutions & Banking
- Securities & SEC

- All Federal

Saturday, October 28, 2017

Possible changes would include loosening qualified asset requirements under risk retention rules, limiting asset-level disclosure under Reg. AB II, and rationalizing capital and liquidity requirements for securitized assets.

The US Treasury Department released a report on October 6 titled "A Financial System That Creates Economic Opportunities: Capital Markets" (the Capital Markets Report),[1] which recommends possible changes to several key regulatory restrictions on securitizations that were adopted in response to the financial crisis.

The Capital Markets Report acknowledges the excesses of the securitization market during the financial crisis, such as a lack of discipline in loan origination and improperly aligned incentives across the securitization production chain. However, it concludes that reforms went too far towards penalizing securitization relative to other funding sources, which dampened the attractiveness of securitization and cut off or raised the cost of credit to consumers. In response, the Capital Markets Report proposes changes that include

- establishing expanded classes of qualified assets securitizations of which would be exempt from credit risk retention requirements, including qualified loans for collateralized loan obligation (CLO) transactions;

- review of the minimum five-year holding period for risk retention interests in residential mortgage-backed securities (RMBS) transactions;
- reducing the number of reporting fields for asset classes subject to Reg. AB II's asset-level data requirements, and providing a "provide or explain" option for some fields;
- review of the three-business-day advance filing requirement for preliminary prospectuses under Regulation AB II, with possible reductions on an asset class-specific basis;
- ·no extension of asset-level data disclosure requirements to Rule 144-A offerings or to asset-backed securities (ABS) backed by asset classes other than those to which they already apply;
- adjusting bank capital requirements for securitization exposures and liquidity requirements for high-quality securitized obligations;
- principles-based rulemaking by the US Securities and Exchange Commission (SEC); and
- the SEC's avoidance of the imposing new requirements by no-action letter, interpretation, or any guidance other than formal rulemaking.

In addition to securitization matters, the Capital Markets Report also addresses access to capital, the equity markets, the Treasury market, corporate bond liquidity, derivatives, financial market utilities, regulatory structure and process, and international regulatory issues.

Some of the proposed changes would merely fine-tune existing rules or practices, while others are more fundamental. In any event, because all of them would require significant action by other regulatory agencies and (in some instances) the US Congress, when and how they will be implemented remains to be seen.

Credit Risk Retention

Under Section 941(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act), a sponsor of a securitization generally is responsible for retaining not less than five percent of the credit risk of any asset that, through the issuance of ABS, is transferred, sold, or conveyed to a third party. The credit risk retention rules implementing this requirement were adopted jointly by the SEC, the Department of the Treasury, the Office of the Comptroller of the Currency (the OCC), the Board of Governors of the Federal Reserve System (the Federal Reserve), the Federal Deposit Insurance Corporation (the FDIC), the Federal Housing Finance Agency, and the Department of Housing and Urban Development,[2] and any changes would require coordinated action by the same group of agencies.

For most securitizations, risk retention may take any of three forms provided by the so-called "standard" approach: an eligible vertical interest, an eligible horizontal interest, or a combination of the two. However, the Dodd-Frank Act exempts from the risk retention requirements any ABS collateralized solely by "qualified residential mortgages" (QRMs), which the adopting agencies defined to be equivalent to "qualified mortgages" as defined in the ability-to-repay rules adopted by the Consumer Financial Protection Bureau. The Capital Markets Report reiterates the recommendation set forth in the Banking Report that

- The risk retention requirement for RMBS should be substantially revised or repealed.

The Dodd-Frank Act also directed the adopting agencies to provide for less than five percent risk retention for ABS backed by commercial real estate loans, other commercial loans, auto loans, and any other asset class that they deemed appropriate, where the underlying loans satisfy underwriting standards that indicated low credit risk (*i.e.*, they are also "qualified assets"). According to the Capital Markets Report, the regulators did not undertake a sufficiently robust economic analysis when setting the requirements for qualified asset classes other than mortgages. In response, the Capital Markets Report recommends that

- Qualified asset exemptions should be expanded across eligible asset classes based on their particular characteristics, after further notice-and-comment rulemaking.

Under the risk retention rules, risk retention held by RMBS sponsors (of non-QRM securitizations) and CMBS third-party B piece buyers generally may not be transferred or hedged for at least five years,[3] whereas for other classes of ABS the minimum risk retention period is two years.[4] The Capital Markets Report recommends that

- The mandatory five-year holding period for RMBS sponsors and CMBS third-party B piece buyers should be reviewed, and shortened accordingly if the emergence period for underwriting-related losses is less than five years.

For CLOs, the rules impose risk retention requirements on the CLO manager, because of the view that a CLO manager indirectly transfers the assets to the issuer by virtue of its authority to select the pool assets, to direct the issuing entity to purchase the pool assets, and to manage those assets once purchased. However, according to the Capital Markets Report, because CLO managers do not originate the pool assets and are compensated with contingent management fees, they are more like asset managers. Also, they may have limited access to capital, and the departure of smaller CLO managers from the market could cause an unhealthy consolidation of the number of CLO issuers. Therefore, the Capital Markets Report recommends that

- Regulators adopt a broad qualified asset exemption method for CLO risk retention based on loan-specific requirements.

In the Capital Markets Report, the Treasury Department notes the challenge of coordinating all of the relevant agencies to issue interpretive guidance or exemptive relief under the rules. Therefore, the Capital Markets Report reiterates the recommendation from the Banking Report that

- Congress should designate a lead agency to be responsible for future rulemaking actions under the credit risk retention rules.

Regulation AB Disclosure Requirements

Disclosure for registered public offerings is governed by Regulation AB, a comprehensive set of rules that was amended in 2014 in response to the financial crisis with a number of revisions commonly known as "Regulation AB II."[5]

Historically, Reg. AB required only pool-level information regarding the pool assets, rather than detailed asset-level data. Therefore, standard data points and formats did not exist. Reg. AB II requires a variety of specific loan-level disclosures for ABS backed by residential mortgages, commercial mortgages, auto loans or leases, repacks of corporate debt, and resecuritizations, the number of which ranges from 60 for debt repacks to 270 for RMBS. According to the Treasury Department, this level of disclosure can actually serve to obscure material information, and issuers have attributed a negative impact on deal volume to the cost and compliance burdens of these requirements. As a result, the Capital Markets Report recommends that

- the number of required asset-level reporting fields should be reduced, because fewer fields are needed to achieve a sufficient level of transparency and standardization; and
- the SEC should consider instituting a "provide or explain" regime for certain data fields, under which certain fields could be omitted if the issuer explains the omission.

The SEC's proposals to expand asset-level disclosure to other asset classes (such as equipment floorplan leases and loans, credit card receivables and student loans) remain outstanding, as does the SEC's proposal to require Reg. AB-level disclosure requirements in Rule 144A offerings of ABS. The Capital Markets Report recommends that

- the SEC should "signal" that it will not extend asset-level data requirements to additional asset classes such as equipment floorplan leases and loans, credit card receivables, and student loans, because grouped account data disclosures should provide sufficient disclosure; and
- Reg. AB-level disclosure should not be extended to Rule 144A offerings of ABS.

Reg. AB II requires that an ABS issuer file a preliminary prospectus containing any required asset-level information at least three business days before pricing, in an effort to mitigate pressure that was felt by investors to forego independent diligence and rely on credit ratings. The Treasury Department notes that issuers face the risk of price movement during this period, and field standardization should facilitate faster analysis than three business days. Therefore, the Capital Markets Report recommends that

- The SEC should review the mandatory three-business-day waiting period between filing the preliminary prospectus and pricing, with possible reductions to one or two business days depending on the asset class.

Capital and Liquidity Requirements

Banking institutions typically derive a risk weight for securitization exposures under one of two approaches. The simplified supervisory formula approach (SSFA) considers a variety of risk factors to determine an aggregate risk weight, then imposes a supervisory surcharge (the p factor) that represents a multiple above the disaggregated loan capital charge required to hold the collateral in the form of a securitization. The p factor for securitizations is currently 0.5, representing a 50% surcharge, and the Basel Committee on Banking Supervision (Basel Committee) has proposed raising it to 1.0 for a traditional security, which would represent a 100% surcharge. A bank gets no credit for purchasing a securitization interest at below its par value. Securitization exposures (other than agency mortgage-backed securities) carry a risk weight floor of 20%, but the Basel Committee has lowered the recommended floor to 15% and the European Banking Authority has recommended lowering the capital floor for qualifying senior tranches.

Some bank holding companies use the supervisory formula approach (SSA) under the advance approach risk-based capital rule. The SSA requires additional parameters beyond SSFA, but both approaches may result in a higher capital charge for holding securitized assets as opposed to directly holding the underlying assets.

In response, the Capital Markets Report recommends that

- regulators should rationalize the capital required to hold securitized products with the capital that would be required to hold the underlying assets directly;
- capital requirements should be set in a manner that neither encourages nor discourages securitization relative to other funding source;
- both SSA and SSFA parameters should be adjusted;
- the "punitive" 50% surcharge resulting from the p factor for securitizations should, at a minimum, not be increased;
- SFA should recognize the added credit support when a bank holds securitization interests at a discount to par value; and
- the risk weight floor for securitization exposures should be reduced to 15%, in accordance with the Basel Committee recommendation, in order to help ensure a level playing field for US banks with respect to their foreign bank competitors.

Risk-based capital for securitizations is held against consolidated balance sheet assets, and under generally accepted accounting principles, a bank securitizer may be required to consolidate a securitization trust onto its balance sheet if it maintains a "controlling financial interest" in the trust. This means that a sponsoring bank may be required to hold capital against a pool of assets even after it has divested associated risk via securitization, which means it may be required to hold duplicative capital against the same exposure. In response, the Capital Markets Report recommends that

- Bank capital for securitization exposures should account for credit risk divested through securitization rather than tying capital requirements to accounting consolidation of the trust.

Banks must hold additional capital against securitized products held in their trading books. In 2016, the Basel Committee issued an update on minimum capital market risks, known as the Fundamental Review of the Trading Book (FRTB). The FRTB would require banks to hold enough capital to withstand large credit shocks, even where the severity of those shocks is not connected to the credit quality of the underlying collateral. While the FRTB has not yet been implemented in the United States, it would, according to the Treasury Department, make secondary market-making in ABS uneconomical, thereby reducing liquidity. In response, the Capital Markets Report proposes that

- Regulators should consider the impact of FRTB and other capital standards on secondary markets, and recalibrate them so that the required capital does not exceed the maximum exposure on the underlying bond due to duplicative capital requirements.

According to the Treasury Department, the “punitive” treatment of securitized products under the bank stress testing requirements of the Comprehensive Capital Analysis and Review (CCAR) and the Dodd-Frank Act further inhibits their liquidity. The Federal Reserve’s current global market shock assumptions for the trading book require banks to apply the peak-to-trough changes in comparable asset valuations from the 2007-2009 period, which are not tailored sufficiently to collateral quality or other safeguards that have become common since the credit crisis. In response, the Capital Markets Report recommends that:

- The Federal Reserve should consider adjusting its global market shock assumptions to more fully consider the credit quality of the pool assets and market reforms implemented since the credit crisis.

Any of these changes to bank capital rules would require interagency cooperation and agreement among the OCC, the FDIC, and the Federal Reserve, and involve a notice and comment process that can take years. For example, the Liquidity Coverage Ratio (LCR) regulations were first proposed in November 2013, were issued in final form in October 2014, and went into effect in January 2015.

Basel III provides two global liquidity standards, the LCR and the Net Stable Funding Ratio (NSFR). The LCR was designed to make sure banks maintain sufficient unencumbered high-quality liquid assets (HQLA) to weather cash outflows during a 30-day period of economic stress. Assets are designated as HQLA based on their liquidity and marketability on a scale encompassing level 1 liquid assets, level 2A liquid assets and level 3A liquid assets, with the latter two categories being subject to haircuts and caps.

In implementing LCR, US regulators excluded all non-agency securitized products from HQLA status, regardless of seniority and performance history. The Basel III LCR allowed regulators to consider including non-agency residential security as level 2B HQLA. According to the Capital Markets Report, the assumption that all securitizations would be illiquid in times of market stress ignores market changes since the financial crisis and the role that the lack of transparency played in the financial crisis. Also, other asset classes that experienced similar or worse illiquidity than ABS during the financial crisis, such as corporate debt, are permitted to count as HQLA if they have a proven track record of liquidity and meet other requirements. In response, the Capital Markets Report recommends that

- High-quality securitized obligations with a proven track record should receive consideration as level 2B HQLA, subject to criteria that establish a proven track record of liquidity and other criteria that are applied to determine the eligibility of corporate debt.

Regulatory Structure and Process

The Capital Markets Report contains an extensive discussion of various issues on the regulatory process generally. Among other things, it encourages transparency, common sense, and an outcome-based approach, recommending

- The increased use by the SEC of advance notices of proposed rulemaking, regular period review of agency rules for burden, relevance, and other factors, and the use of principles-based regulations where appropriate.

The Capital Markets report also notes that the SEC often provides regulatory guidance outside of the official notice and comment process, including in rulemaking releases (when not disclosed at the proposal stage), no-action letters, technical materials (including compliance and disclosure interpretations), comment letters to registrants, staff legal bulletins, and speeches. While the Treasury Department notes that there are appropriate circumstances in which guidance is appropriate, there is a risk of the inappropriate use of guidance as a substitute for formal rulemaking. Therefore, the Capital Markets Report recommends that

- The SEC should avoid imposing new requirements by means of interpretive guidance, and revisit any existing guidance that has caused market confusion or regulatory challenges.

Conclusion

The Capital Markets Report addresses a wide range of issues, including many that are focused on the securitization markets.

Many of the proposed changes would merely fine-tune existing rules or practices. These proposals include revisiting the requirements for various categories of "qualified assets" that are exempt from credit risk retention because their inherent quality already addresses the primary purpose behind the rules, and non-adoption of the outstanding SEC proposals to extend asset-level data requirements to other asset classes and to extend Regulation AB-level disclosure requirements to Rule 144A offerings of ABS.

Other proposed changes would be more fundamental. For example, while problems with the RMBS markets were widely perceived as being one of the drivers of the financial crisis, the Capital Markets Report reiterates the Treasury Department's proposal to revise or even eliminate credit risk retention requirements for this asset class. Limiting the ability of the SEC to give guidance outside the formal rulemaking process may help eliminate the imposition of new substantive requirements by information interpretation, but may also further reduce the usefulness of engaging in regulatory dialog about questions that arise when implementing unclear requirements, particularly in the principles-based environment advocated by the Treasury Department.

In any event, the Capital Markets Report (like the Banking Report before it) is more of a conceptual wish list than a specific action plan. While the Treasury Department's recommendations may have the imprimatur of the administration, none of the securitization proposals are detailed or self-executing. All would require significant action from other agencies, ranging from regulatory action by the SEC, to coordinated regulatory action among groups of agencies that may have different views and agendas (in the case of most of the proposed risk retention changes and changes to bank capital rules), to new lawmaking by a divided and fractious Congress (to designate a lead agency to run point on risk retention issues). If and when these recommendations are implemented, and in what form, remains to be seen.

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[1] The Capital Markets Report, which is available here, was produced in response to Executive Order 12772 issued on February 3, 2017 by President Trump. This order requires the Treasury Department to identify laws and regulations that promote or inhibit federal regulation of the US financial system in a manner consistent with several core principles, including fostering economic growth, encouraging American competitiveness, making regulation more efficient, effective and appropriately tailored, and rationalizing the federal financial regulatory framework. A prior report issued in June on the banking system, titled “A Financial System That Creates Economic Opportunities: Banks and Credit Unions” (the Banking Report) is available here.

[2] For more details on the credit risk retention rules, see Morgan Lewis’s publication titled “A Guide to the Credit Risk Retention Rules for Securitizations.” Morgan Lewis previously analyzed the issues involved in identifying the sponsor of a securitization transaction in our Law Flash entitled “Credit Risk Retention: Who Is the Sponsor of a Securitization?”, addressed the difficulty of simultaneously complying with both the US and EU credit risk retention rules in our LawFlash titled “Multijurisdictional Securitization in the Age of Risk Retention,” and discussed the issues involved in structuring permitted financing of credit risk retention interests in our LawFlash titled “Credit Risk Retention Financing: Threading the Needle”.

[3] Until the later of: (a) five years after the closing date; and (b) the date that the total unpaid principal balance of the underlying mortgages has been reduced to 25% of the unpaid principal balance as of closing date; but no later than seven years after the closing date.

[4] The latest of: (a) the date that the total unpaid principal balance (if applicable) of the securitized assets has been

reduced to 33% of the cut-off date unpaid principal balance; (b) the date that the total unpaid principal balance of the ABS interests issued has been reduced to 33% of the closing date unpaid principal balance; and (c) two years after the closing date.

[5] For more details on Regulation AB II, see Morgan Lewis’s publication titled “A Guide to Regulation AB II.”

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