

SECURITIZATION – NEW DEVELOPMENTS

Introduction

- The face of securitization is undergoing significant restructuring
- In 2007, securitization was multi-trillion dollar market, and growing
- Billion dollar transactions were frequent
- Deals became more and more complex, utilizing intricate derivatives, and allocating slices of risk to yield-hungry investors
- This stupendous growth was fueled by investors - their purchases of securities provided the cash that greased the wheels of this non-stop financial engine
- The basic concept of many of these transactions was relatively straightforward:
 - ▶ a bank makes loans to individual or corporate customers
 - ▶ the bank pools the loans and sells them to an LLC or other entity specifically created for the transaction - a special purpose vehicle or SPV
 - ▶ the SPV issues securities that are secured, or backed, by the loans
 - ▶ one class of the securities is designed to be paid first from the amounts the SPV receives from its loans
 - ▶ the rating agencies analyze the loans and the structure, apply their models to determine the likelihood that this first class of securities will default, and conclude that the risk is sufficiently low that they deserve a AAA rating – and the securities are purchased by investors looking for the safest of investments
 - ▶ a second class of the SPV's securities are next in line to be paid; while they are therefore a little riskier than the AAA class, the rating agencies' models still view them as extremely unlikely to default, and award them a AA rating – still very attractive to investors
 - ▶ and then an A-rated class of securities, and a BBB class – each class is a little riskier than the last, and therefore pays a higher interest rate; but none of these securities is expected to default since they all have Investment Grade ratings
- But they did default – racking up massive multi-billion dollar losses that came to endanger the world's financial system

- Losses for investors who purchased the securities; losses for investment banks that structured the securities and retained vast amounts or held them in off-balance sheet entities; losses for insurers that guaranteed the securities; and losses for credit default swap counterparties that bet the securities wouldn't fail
- How did this happen? Is the securitization model fatally flawed?
- 20-20 hindsight suggests that securitization can work as intended – but only if all participants involved in creating, rating and purchasing asset-backed securities properly play their assigned roles
- What happened was a Perfect Storm of multiple failures to do so:
 - ▶ lenders abandoned their traditional underwriting standards – partly because they had eager buyers for their loans and therefore bore no risk if a borrower defaulted
 - ▶ rating agency models assumed ever-rising house prices – which would have permitted borrowers to refinance loans they were otherwise unable to carry
 - ▶ many investors bought off the ratings – rather than conducting their own analysis
 - ▶ insurers bet their capital on these ratings and on their own belief in an ever-rising real estate market
 - ▶ unregulated derivatives permitted multi-billion dollar bets on the same belief
- All of which has prompted governments and regulators to rethink securitization's role and how it (and its participants) should be structured and regulated
- Two other preliminary thoughts:
 - ▶ the classic securitization model of raising funds backed by well-underwritten financial assets, that are isolated from their originators' insolvency risk, has the proven capacity to provide businesses with new sources of funds, at favorable capital market rates
 - ▶ governments recognize that securitized funding is used to extend cost-effective credit to small business & consumers – through business loans, mortgage loans and car leases (that are then pooled and securitized to raise further funds in the capital markets) – enabling these businesses & consumers to make the purchases of goods & services necessary for a strong economy; securitization has contributed to approximately 40% of credit granted in the U.S. over the past 15 years.

Treasury Secretary Geithner: "...no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to consumers and businesses – large and small"

Fixes, Fixes and Other Developments

- Investigations, fines & penalties – for failures of omission and commission:
 - ▶ SEC – did Goldman Sachs & Morgan Stanley provide insufficient information to investors?
 - ▶ NY AG – did 8 banks provide false info to rating agencies to get better ratings on risky securities?
 - ▶ California AG – action to require Moody's to respond to subpoena seeking "information regarding Moody's decision to give its highest credit ratings to securities backed by risky and toxic mortgage-backed securities"
 - ▶ Canada too – seven financial institutions fined \$138.8 million for their roles in \$32 billion ABCP meltdown; Coventry (and two officers) under investigation by the Ontario Securities Commission for faulty disclosure as to the extent to which its ABCP was tied to U.S. subprime mortgages
 - ▶ Lehman's bankruptcy examiner reports Lehman used accounting maneuver Repo 105 to sell "toxic" securities at the end of a quarter, remove them from its balance sheet (which grew by a fictitious \$50 billion), and then repurchase the securities after quarter end; SEC questioning the 19 largest U.S. banks as to their use of Repo 105
- Restoring American Financial Stability Act of 2010:
 - ▶ 5% risk retention (skin-in-the-game) to encourage sound lending practices - with possible exemption for high quality "qualified mortgages" (e.g., fully documented, and having a 20% down payment or carrying mortgage insurance)
 - ▶ elimination of steering payments – "brokers and originators have been in a very awkward position where they have been paid bonuses for making a deal that it is not in their client's interest." (May 12, 2010 amendment)
 - ▶ new minimum underwriting standards for residential mortgage loans – lender required to determine that borrower has "a reasonable ability to repay the loan" based on "verified and documented information". End of liar loans. (May 12, 2010 amendment)

- ▶ regulator to determine what structures will satisfy the risk retention requirement for commercial mortgage securitizations (including representations & warranties, third party investors, and adequate underwriting standards & controls) (May 12, 2010 amendment)
- ▶ if issuer of a structured finance product wants it rated, it will be required to apply to a self-regulatory organization - the Credit Rating Agency Board – to assign a “qualified” nationally recognized statistical rating organization to issue the initial credit rating, rather than being able to directly approach the rating agency of its choice, with the intent to “encourage competition and—get this—accuracy” (May 13, 2010 amendment)
- Regulation of the OTC derivatives market:
 - ▶ Wall Street Transparency and Accountability Act of 2010 would make sweeping changes to the derivatives market to address concerns caused by the failure of Lehman and the bailout of AIG, both caused in part by their use of unregulated derivatives
 - ▶ proposes mandatory clearing and exchange trading for certain transactions, registration and regulatory requirements for derivatives dealers, capital and margin requirements, segregation requirements, position limits and fiduciary obligations to certain counterparties
 - ▶ broad definitions of “swaps” and “security-based swaps” would cover the range of derivative products currently traded in the over-the-counter market
 - ▶ would prohibit U.S. Federal assistance to derivatives dealers and other swap entities, which could result in banks moving their derivatives business into separate entities so that the banks will remain eligible for such assistance; may result in bank-related dealers exiting this business
- Regulation of Credit Default Insurance:
 - ▶ Bill introduced in NY to regulate the sale of credit default insurance – insurer must obtain security for insured mortgage-backed securities; insured ABS must meet specified requirements intended to reduce risk; maximum permitted exposure to each issue of insured ABS
 - ▶ Bill would ban “naked” credit default swaps (where beneficiary/insured does not have a material interest in the default of the insured debt obligation) and require permitted credit default swaps to be written as insurance by licensed credit default insurance companies

- ▶ introduced May/2010
- Safe harbor protection for treatment by the FDIC as conservator or receiver of financial assets transferred by FDIC-regulated banks in connection with a securitization or participation after September 30, 2010:
 - ▶ to provide investors of ABS that are backed by bank-originated loans comfort that the FDIC will not use its statutory authority to disaffirm or repudiate contracts in order to reclaim the loans if the bank fails
 - ▶ since 2000, FDIC's safe harbor protection for securitizations applied only if the transaction satisfied GAAP rules for an accounting sale
 - ▶ accounting rules introduced in 2009 make it more difficult for securitizations to achieve accounting sale treatment
 - ▶ new safe harbor rules would provide for "legal isolation" (i.e., free from FDIC recourse) even if securitization fails to amount to a GAAP sale
 - ▶ safe harbor conditioned on transaction satisfying several conditions relating to such matters as risk retention by the securitizing bank, number of tranches, credit support, disclosure, documentation requirements, servicing standards, loan origination standards and rating agency compensation
 - ▶ released May 11, 2010
- Rule 17g-5 of Securities Exchange Act of 1934: Amendments to Rules for Nationally Recognized Statistical Rating Organizations:
 - ▶ sets forth requirements for NRSROs hired by issuers, underwriters or sponsors ("arrangers") to provide credit ratings for securitizations
 - ▶ requires arranger to post information provided to hired NRSROs on a password-protected website and make it available to non-hired NRSROs
 - ▶ compliance date is June 2, 2010
- SEC Reg AB II – 667 page overhaul of offering process (registration), disclosure, reporting and other rules relating to public and private ABS transactions:
 - ▶ proposed changes include: requiring a non-hedged 5% risk retention to qualify for shelf registration, third party evaluation of repurchase obligations (for sold assets that breach reps & warranties), more granular (loan level) disclosure of securitized assets, creation of a "waterfall" computer program (utilizing Python

open-source programming language) to permit analysis of a transaction's loan-level data and cash flows

- ▶ SEC concerned that these proposals may lead issuers to increased use of the private markets to issue ABS – and therefore is re-examining the assumption that sophisticated investors do not need the protections that come with registration; Rule 144A private placement investors to be entitled to request the same information that would be available through a registered offering
- ▶ announced April 7, 2010; published May 3, 2010; comment deadline August 2, 2010
- Covered Bond Legislation
 - ▶ the new new thing? First covered bond issued in 1769 when King Frederick the Great of Prussia needed to rebuild the country after the Seven Years War
 - ▶ United States Covered Bond Act of 2010; would create a European-like legal regime for covered bonds
 - ▶ features would include (i) independent asset monitor; (ii) asset coverage test; (iii) isolation of cover pool in the event of issuer's bankruptcy; (iv) covered bond regulator (Secretary of the Treasury) to be trustee of isolated pool for the benefit of the covered bondholders; (v) limited to specified types of financial institutions and specified cover pool asset classes (including residential and commercial mortgages, auto loans, credit card receivables, student loans , small business loans and others designated by covered bond regulator)
 - ▶ Canada's covered bond legislation soon to be introduced
- Accounting
 - ▶ rollercoaster ride of changes: FAS 77 (off-balance sheet accounting sale if disclose recourse); FAS 140 (accounting sale if have legal true sale); FIN 46/FIN 46R (must consolidate if have majority of risks or rewards, with heavily used exemption for "brain dead" Qualified Special Purpose Entities); FAS 166/167 (materially changes the way entities account for securitizations and special-purpose entities; accounting sale for many securitizations unlikely; QSPE exemption abolished)
 - ▶ FAS 167 – securitization SPE must be consolidated by the entity that has the "**controlling financial interest**" in the SPE, being the entity that has (i) the power to direct the SPE's activities that most significantly impact its financial performance **and** (ii) the obligation to absorb losses of the SPE or the right to receive benefits from the SPE that could potentially be significant to the SPE

- ▶ FAS 166 - transfer of financial assets will be treated as a sale for accounting purposes only if the transferor and its consolidated affiliates that are included in any relevant financial statements (including SPEs that are consolidated under FAS 167) have **surrendered control** over the transferred assets; control is surrendered only if (i) the assets are legally isolated (a legal “true sale”), (ii) the transferee (or each third party holder of its beneficial interests) has the ability to pledge or exchange the assets and (iii) the transferor otherwise no longer maintains effective control over the assets

- ▶ bottom line: JP Morgan has consolidated its credit card securitization trusts, bank-administered asset-backed commercial paper conduits, and certain mortgage and other consumer securitization entities, and thereby (i) added approximately \$88 billion of assets and \$92 billion of liabilities to its consolidated balance sheet, (ii) reduced stockholders’ equity by approximately \$4 billion, and (iii) reduced its Tier 1 capital ratio by approximately 30 basis points mostly as a result of establishing an allowance for loan losses of approximately \$7 billion (pre-tax) related to the receivables held in its consolidated credit card securitization trusts – as explained in **17 pages of footnotes** in its annual report

- General Growth Properties:
 - ▶ 166 “bankruptcy remote” special purpose entities filed for bankruptcy; court approved filing because, although not insolvent, the SPEs were in “financial distress” (due to cross defaults and the impact of the credit markets on their ability to, eventually, refinance)

 - ▶ not the end of securitization as we know it. SPEs were not substantively consolidated with their insolvent parent, and GGP’s December 1, 2009 reorganization plan suggests that the SPE structure ended up enabling the SPEs’ lenders to obtain favorable restructuring terms

 - ▶ lessons learned (as gleaned from terms of the restructuring plan negotiated by the SPEs’ lenders to deal with any subsequent insolvency) – more lender control on appointment and removal of independent directors; use of Delaware limited liability companies that are able to limit their directors’ fiduciary duties to a greater extent than is possible with corporate directors; require directors to consider the interests of the SPE as a stand-alone business entity and the interests of its lenders when determining whether to file for bankruptcy

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