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Banks Gain Leeway in Retention of Loan Risk

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WASHINGTON - Although bankers are likely to have significant concerns about the risk-retention proposal due next week, they appear to have scored at least one victory already: a choice over how to structure risk that must be retained.

Under the plan, lenders would have to retain 5% of the risk of any loan - or pool of loans - they sell into the secondary market. But it has been unclear until now how that risk would be structured - namely, whether lenders would have to retain 5% of the overall risk or 5% of each tranche.

According to sources familiar with the risk-retention proposal, regulators are expected to give lenders a choice on that critical question, which will please bankers but likely raise concerns about whether they are giving institutions too much leeway.

"The issuers will very much appreciate the ability to choose the form of risk retention for their transaction," said Tom Deutsch, executive director of the American Securitization Forum. "There are some investors who will be very concerned about those choices. Some investors would like to see a one-size-fits-best approach, but different issuers in different asset classes would be very concerned with that."

At issue is whether lenders must retain a so-called horizontal or vertical slice of the risk. A horizontal slice would require lenders to take a 5% first-loss interest in the overall securitization structure, while a vertical, or pro-rata piece, would require lenders to keep 5% of every piece of it, such as subordinated and senior tranches.

When the Federal Deposit Insurance Corp. board meets on Tuesday, the proposal is expected to let lenders take either approach or an "L-shaped" combination.

Karen Shaw Petrou, managing director of Federal Financial Analytics Inc., was cautiously optimistic about the flexibility, given how much else is in the rule. Bankers still will likely have several other objections to the plan, she said.

"It may ameliorate some concerns, but it certainly won't send them off celebrating," she said.

The question of how to structure retained risk may be of more importance depending on how regulators structure another part of the plan - the qualifying residential mortgage test, which exempts loans fitting certain criteria from any risk-retention requirements. At the very least, credit card loans and student loans, which are also covered by the risk-retention plan, would not be eligible for QRM. But the industry is also worried that regulators are drafting QRM requirements very narrowly, leaving many mortgages outside of the exception.

"If you exempt the range of low-risk mortgages that we think should be exempted in safe harbor, the question of vertical versus horizontal becomes somewhat less significant," said Bob Davis, executive vice president of government relations for the American Bankers Association. "If you get that question right, I think the decision on the vertical versus horizontal becomes less critical. To the extent there is a narrower safe harbor, the decision on vertical versus horizontal will become more important."

Federal regulators signaled early on they were aware how much difference it could make.

"If a securitizer or originator retains a piece of each tranche of securities sold to investors (a vertical slice), the securitizer or originator will retain exposure to the varying degrees of credit risk of the tranche holders," the Federal Reserve Board wrote in an October report to Congress. "Likewise, an originator or securitizer can retain credit risk by retaining a portion of the subordinate piece of the security (a horizontal slice). Credit risk is concentrated in this security, so retaining even a small part of the subordinate piece exposes the seller to a relatively larger share of the deal's total credit risk."

Having a choice will benefit banks since different institutions likely differ on which they prefer. Taking a vertical slice of risk is likely to help banks that do not want to hold more risk-based capital since their overall exposure is not as great as taking a horizontal piece of the risk. But the horizontal option may benefit institutions that deal in consumer securities, such as student loans and credit cards, as well as nonbanks.

"Whether a party favors risk retention in the form of a vertical slice or a horizontal slice depends on which market they are in, what role they play in the servicing or securitization process, and other factors like cash constraints and risk-based capital constraints," said Jim Gross, associate vice president of accounting, tax and bank regulation at the Mortgage Bankers Association.

"For example, an issuer who is concerned about the amount of cash required to make a 5% investment in all tranches of a securitization and is not risk adverse, would likely favor a horizontal strip which would require a much smaller investment of cash," Gross said. "In contrast, if you are a bank and concerned about risk-based capital and are risk-averse, the vertical strip might be more attractive because there would be less probability of consolidating all of a securitization's assets and liabilities on your balance sheet and you take only a 5% portion of the first-loss tranche."

Deutsch agreed, saying that's why the industry will be grateful for the flexibility.

"Nonbanks like Ford Motor Credit could care less about consolidation because they don't have to hold capital, because they are not a bank," Deutsch said. "A lot of the consumer nonbank issuers would substantially prefer to have a first-loss position, because they currently structure their existing transactions that way, and certainly there has been no indication that consumer asset-backed securities transactions have not fared well through one of the worst financial crisis in American history."

Some industry observers, however, argue that regulators are making a mistake, and that one structure is better than the other. Problem is, they disagree on which one is better.

Stephen Ornstein, a partner at SNR Denton, said a vertical slice would be the superior form of risk retention.

"The vertical would be a bigger slice of the pie, so I think for the purposes of the rule we are expecting it to be that, vertical," he said. "The vertical makes the most amount of sense because you are taking a piece of each risk. It depends where the horizontal is. The horizontal could be the riskiest part or the less risky."

Mark Calabria, director of financial regulations studies at the Cato Institute, said regulators should encourage taking a horizontal slice.

"Either you take the first loss or you take a piece of every loss," he said. "It doesn't strike me that regulators will go the direction of making you take every piece of it. It greatly complicates the process. It sounds something like contingent capital in the sense bank regulators talk about it all the time, but they never seem to put a proposal in place because it never works like it's structured."

What a bank prefers appears to depend on what type of institution is taking the risk. A horizontal slice would consolidate the accounting for the security, but would in turn lead to higher capital requirements. So some industry players are likely to prefer the vertical slice.

"We think that a vertical slice would be less disruptive to the market because of the accounting and capital implications of a horizontal slice," said Stephen O'Connor, senior vice president of public policy and industry relations for the MBA.

Tim Rood, a partner and managing director of Collingwood Group, said the vertical approach does not accomplish the goal of risk retention.

"When you start getting into the vertical, you look like financial engineering, which is leveraging our risk which got us into this mess in the first place," he said. "I don't remember this working out so well with investors and private-label mortgage-backed securities."

He praises the horizontal form of securitization.

"The one most closely aligned with the intended purpose of risk retention appears to be the horizontal option," Rood said. "If you think about it in the purest sense, the 5% was supposed to be a handicap and be the most pure of the options. It's easy to calculate. It's pure and simple in the sense that it's very consistent with traditional risk management ... you are setting aside what is for your potential rainy-day fund."

Jeffrey Naimon, a partner at BuckleySandler LLP, agreed.

"The vertical slice where you have to hold a certain percentage of every different type of security that comes off, I think that will make for very difficult risk management," Naimon said. "From a risk management perspective back at the bank, if you do this securitization and you have to hold this slice of risk across everything, I think that would make it difficult to understand every level of risk. I think the policy goal of risk retention is without doing the vertical strip, because the point is you have skin in the game, you are not selling the underlying asset of securities that are not fundamentally flawed and you have an interest in making sure the assets they are selling are good."

Petrou, however, said that by taking an interest in each securitized pool through a vertical slice, there will be less of an opportunity to manipulate the system.

"The vertical is the more straightforward way to go," she said. "It's harder to game than horizontal if you define what part of horizontal you take. ... Depending on how they phrase it, the goal should be preventing gaming through ever more complex securitization structures that bury the risk retention so regulators can't find it. It really depends and horizontal could do that."

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