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Commercial Real Estate

Big Banks Fear Retention Rule Will Destroy Securitization Market

By Donna Borak

WASHINGTON - The list of objections to the risk retention proposal appears endless.

While most of the attention so far has focused on an exemption to the plan for "qualified residential mortgages," bankers' fears about the proposal go far beyond that.

In dozens of comment letters, including hundreds of pages written by the biggest banks, the industry is objecting to nearly every part of the plan, including how it defines key terms, what asset classes it would cover, and some provisions bankers consider unworkable. If left unchanged, they say, the rule could destroy the securitization market.

"We believe the rules as currently proposed embed in the regulatory framework excessive cost and complexity that could impede the revitalization of healthy securitization and housing markets, and potentially unduly restrict credit availability for a majority of consumers, contravening stated policy goals of both Congress and the White House," wrote Tom Hamilton, managing director, head of securitized products trading at Barclays Capital Inc.

Barclays was joined by many other large institutions, including Bank of America Corp., Citigroup Inc., Wells Fargo & Co., Redwood Trust Inc., Deutsche Bank AG and Genworth Financial, which wrote a letter totaling 222 pages.

All said the plan may harm an already fragile housing market and urged regulators to move cautiously before issuing a final rule.

"Care must be taken to ensure that the proposed rules do not unintentionally impair the functioning of the securitization markets as viable funding and capital management tools, or result in requirements that are duplicative of, or in conflict with, the risk retention requirements in other jurisdictions," wrote Salvatore Palazzolo, managing director and counsel of Deutsche Bank's New York branch.

Others like Citigroup Global Markets Inc. used the words of regulators themselves to make the case for additional time to study the impact of the rule.

Jeffrey Perlowitz, managing director and co-head of Global Securitized Markets for Citigroup cited a recent Financial Stability Oversight Council report that warned "if regulators set risk retention requirements at an inappropriate level, or design them in an inappropriate manner, the costs in terms of lost long-term output could outweigh the benefits of the regulations," as a reason to take pause.

He also cited a letter by the Senate Banking Committee, which urged regulators to conduct "rigorous cost-benefit and economic impact analysis."

Objections to the plan ran the gamut.

For starters, banks said the retention proposal, which was required by the Dodd-Frank Act and would mandate that securitizers retain at least 5% of the risk of any loan they securitize, was too sweeping because it captured most asset classes.

Stephen D'Antonio, managing director of Morgan Stanley & Co., said retention should only be required where "necessary and appropriate, and not applied in a uniform way to transactions in which the pool assets are of relatively high credit quality."

Risk retention requirements, D'Antonio argued, should focus on problematic asset classes, and not take a one-size-fit-all approach, or else risk curtailing credit availability in certain sectors of the securitization market.

"In the still-weak economic environment, it is important that credit not be arbitrarily denied in all sectors of the securitization market because of the excesses in limited sectors of that market," said D'Antonio.

One such example is collateralized loan obligations, a source of credit used by small- and medium-sized companies that are not large enough to access the corporate bond market.

"Investors in investment grade CLO instruments did not suffer any losses during the financial crisis, yet the proposed rules would, in our view, effectively eliminate the viability of this market," D'Antonio wrote.

Bankers are also concerned because regulators did not make clear whether the basis for calculating risk retention should be par value or fair value. Without making a distinction, regulators would be forgoing establishing a common method to determine the real economic value of the retained risk, bankers said.

Depending on which one was used, it would result in substantially different values for the securities issued in a securitization, wrote Martin Hughes, president and CEO of Redwood Trust.

Palazzolo of Deutsche Bank said that an informally expressed view of "par value" would be interpreted as "market value" requiring an excessively high level of risk retention.

"Dodd-Frank requires credit risk retention, not market value retention. The notion of credit risk is the foundation of the risk retention rules. It also appears to be the source of fundamental confusion," said Palazzolo.

Others objected to uncertainty regarding the meanings of asset-backed securities interest and gross proceeds under the plan.

"These terms are crucial and necessary components of understanding how risk retention will be applied," wrote Citigroup's Perlowitz. "Without a firm understanding of these terms, industry participants must guess on how the proposing release will be applied, and they will not be able to accurately assess the impact of the proposing release."

Similarly, but even more pressing among those in the industry, is a proposed requirement that banks keep a "premium capture cash reserve account." Under the plan, securitizers would be required to create a cash account in order to prevent the monetization of excess spreads.

But Deutsche Bank and others said such a requirement would wreak havoc in the market and goes beyond Congressional intent.

"Premium capture appears to serve no purpose other than to eliminate economic incentives for sponsors, and limit the ability to structure transactions that are responsive to investor demand," wrote Palazzolo.

Kenneth Miller, Bank of America's deputy general counsel, noted that the premium capture cash reserve account could put at significant risk, or even eliminate, the sponsor's financial incentive to originate and securitize commercial real estate assets.

"Without a financial incentive to securitize, the commercial mortgage-backed securities market will severely contract or close completely, thereby significantly reducing liquidity to the CRE market, which will result in a lower loan origination and higher borrowing costs," wrote Miller.

Saiyid Naqvi, the president and CEO of PNC Mortgage, agreed.

"The PCCRA as proposed would substantially penalize certain types of securitizations even absent the monetization of excess spread and would be inconsistent transaction-to-transaction given changes in interest rates and market conditions," wrote Naqvi.

The CMBC market has played an increasingly key role in the financing of multifamily and other commercial real estate and providing a mechanism for bond investors to provide capital to commercial real estate property owners through a securitization vehicle.

The provision drafted by regulators, they argued, would make prime residential mortgage securitizations uneconomic and cause sponsors to require higher mortgage rates of prime borrowers to offset the effect of the premium capture requirement.

Overall, industry representatives suggested regulators need to return to the drawing board as they craft a final rule.

"The risk retention rules need to work to prevent abuses but they should not be crafted so tightly such that securitization becomes unattractive or impossible," warned Timothy Sloan, senior executive vice president and chief financial officer for Wells Fargo, in his letter.

Hughes of Redwood Trust said that if risk retention requirements were too strict, the government would never be able to disentangle itself from the mortgage market.

"Without renewed private investment on terms that are also attractive for borrowers, the government will not be able to accomplish its goal of reducing its current unsustainable level of support for the mortgage market," said Hughes.

