A Guide to the Proposed Credit Risk Retention Rules for Securitizations

April 4, 2011

The Securities and Exchange Commission (the “SEC” or the “Commission”) and various federal banking and housing agencies have proposed broad rules for retention of credit risk in securitizations. The proposed rules would provide several methods of retaining the required risk exposure, as well as limited exceptions for pools of assets that satisfy specified credit criteria.

The proposed rules would apply to sponsors of virtually all securitizations (other than “synthetic” structures), whether the asset-backed securities (“ABS,” as more fully defined below) are publicly or privately offered, and would permit only limited circumstances in which the required risk retention could be held by an originator or other party rather than the sponsor. The required risk could be retained in one of several forms, including vertical, horizontal, L-shaped and representative sample methods, as well as other methods that would apply only to specific types of assets or transactions. The proposed regulations would set strict standards for “qualified residential mortgages” (“QRMs”) that would be exempt from the risk retention requirements, including a 20 percent down payment for purchase financing and a requirement that the loan documents mandate loss mitigation actions that could include loan modifications, and also would exempt several other classes of qualified assets that meet stringent requirements. The proposed rules would discourage the issuance of interest-only securities or other ABS that are sold at a premium by requiring capture of that premium in a “premium capture cash reserve account.” Retained credit risk exposure could generally not be transferred or hedged.

The proposed regulations would be effective one year after publication of final rules in the Federal Register with respect to ABS backed by residential mortgage loans, and two years after publication of final rules for all other securitizations.

Comments on the proposed rules are due by June 10, 2011.

This memorandum summarizes the principal terms of the risk retention rules as proposed. The intent of some of the proposed rules is not entirely clear, even with the benefit of the accompanying commentary. The application and impact of the proposed rules may subsequently be clarified.

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Background

The credit risk retention rules[1] were proposed jointly by the SEC, by the Department of the Treasury, Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation (the "Banking Agencies"), and by the Federal Housing Finance Agency and the Department of Housing and Urban Development (together with the SEC and the Banking Agencies, the "Agencies") to implement the mandate of Section 941(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Section 941(b) of the Dodd-Frank Act has been codified as Section 15G of the Securities Exchange Act of 1934, as amended (the "Exchange Act").

Under Section 15G of the Exchange Act, the SEC and the Banking Agencies were directed to jointly prescribe regulations that require securitizers to retain, generally, not less than 5 percent of the credit risk of any asset that the securitizer, through the issuance of ABS, transfers, sells, or conveys to a third party, subject to certain exceptions. Section 15G provides that securitizers will not be required to retain credit risk for securitized assets if all of the pooled assets are QRMs, as defined by the Agencies. The statute also provides that the regulations must permit securitizers to retain less than 5 percent of the credit risk of securitized commercial loans, commercial real estate loans and consumer automobile loans if the loans meet underwriting standards established by the Banking Agencies. Finally, Section 15G permits allocation of retained credit risk to originators under the regulations where appropriate.

The risk retention requirements of Section 15G and the proposed rules are intended to address perceived problems in the securitization markets by requiring that securitizers, as a general matter, retain an economic interest in the credit risk of the assets they securitize. "[W]hen incentives are not properly aligned and there is a lack of discipline in the origination process," the Agencies state in the joint notice of proposed rulemaking, "securitization can result in harm to investors, consumers, financial institutions, and the financial system. During the financial crisis, securitization displayed significant vulnerabilities to informational and incentive problems among various parties involved in the process." However, "[w]hen securitizers retain a material amount of risk, they have 'skin in the game,' aligning their economic interest with those of investors in asset-backed securities." By requiring that the securitizer retain a portion of the credit risk of the assets being securitized, Section 15G and the proposed rules are intended to provide securitizers an incentive to monitor and ensure the quality of the assets underlying a securitization transaction, and thereby help to align the interests of the securitizer with the interests of investors in ABS.

Multiple alternative forms of risk retention have been proposed, according to the Agencies, to take into account "the diversity of assets that are securitized, the structures historically used in securitizations, and the manner in which securitizers may have retained exposure to the credit risk of the assets they securitize."

Summary

Securitization sponsors generally would be responsible for satisfying the risk retention requirements. Originators could agree to share risk retention in some cases and, as described below, some alternative risk retention methods would permit retention of risk by an originator or third party.

For most securitizations, risk retention could take any of four forms, subject to multiple rigorous and highly technical conditions:

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[1] The complete text of the joint notice of proposed rulemaking (the "NPR") is available at http://www.sec.gov/rules/proposed/2011/34-64148.pdf.

- Vertical: at least 5 percent of each class of ABS interests issued by the issuing entity;
- Horizontal: a residual interest equal to at least 5 percent of the par value of all ABS interests issued by the issuing entity;
- L-shaped: a combination of a vertical slice equal to at least 2.5 percent of each class of ABS interests issued by the issuing entity and a horizontal residual interest equal to at least 2.564 percent of the par value of all ABS interests issued by the issuing entity; and
- Representative sample: a randomly selected representative sample of assets equivalent, in all material respects, to the securitized assets, equal to at least 5.264 percent of the total principal balance of the securitized pool.

Other risk retention options would be available for particular types of transactions, also subject to specified conditions:

- Commercial mortgage-backed securities: the risk retention requirement could be satisfied through retention by a third-party "B-piece buyer" of a residual "B-piece" equal to at least 5 percent of the par value of all ABS interests issued by the issuing entity;
- Revolving asset master trusts: the sponsor could retain a "seller's interest" equal to at least 5 percent of the total principal balance of the pool assets that shares the same risks as investors on a proportionate basis;
- Asset-backed commercial paper conduits: the risk retention requirement could be satisfied through retention by each originator-seller of a residual interest equal to at least 5 percent of the par value of all ABS interests backed directly by that originator's receivables; and
- Securities guaranteed by Fannie Mae and Freddie Mac: the guarantee provided by Fannie Mae or Freddie Mac would satisfy the risk retention requirement.[2]

Only one of these risk retention methods could be employed in any particular ABS transaction; different methods could not be combined, except as permitted by the proposed rules.

Issuance of interest-only securities and other types of ABS sold at a premium to their principal amount could be rendered uneconomical by a mandated "premium capture cash reserve account" that would effectively convert the premium into an additional form of risk retention.

Securitizations of QRMs would be exempt from the risk retention requirement, but QRMs would include only loans with straightforward payment terms whose borrowers satisfy relatively strict credit criteria. QRMs would not include loans that provide for negative amortization, balloon payments, interest-only features or prepayment penalties. Creditors would be required to include in the loan documents a commitment to undertake certain loss mitigation efforts if the loan becomes 90 days delinquent in payment. An exemption would also be available for securitizations of commercial loans, commercial real estate loans and consumer auto loans (but not auto leases) underwritten to high standards.

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[2] This exception would apply while these entities are in federal conservatorship or receivership, and to certain successors.

The proposed rules would also exempt certain securitizations in which the ABS or the pooled assets have the benefit of government guarantees, but do not appear to exempt securitizations of most federally guaranteed student loans.

Sponsors and other parties that retain ABS interests to satisfy the credit risk retention requirement generally would be prohibited from transferring the retained interests (other than to consolidated affiliates), hedging the retained credit risk, or pledging the retained interests on other than a full recourse basis.

Disclosure to investors (and to regulators, upon request) would be required regarding, among other things, the form and amount of risk retention and the assumptions used in determining the total amount of ABS issued.

Who Would Be Required to Retain Credit Risk

Sponsors

Section 15G of the Exchange Act imposes risk retention requirements on any "securitizer" of ABS. As defined, a "securitizer" includes the "person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer,"[3] a phrase which is substantially identical to the definition of "sponsor" under Regulation AB.[4] The proposed rules define "sponsor" in a manner consistent with Regulation AB – except that the definition would be applicable to all securitizations, whether or not subject to the Regulation AB disclosure rules.[5]

The proposed rules generally would require the sponsor, except as described below, to retain the required economic interest in the credit risk of the securitized assets. If there is more than one sponsor, at least one of them would have to retain the required credit risk (except where retention by a third party would satisfy the requirement), though each sponsor would be responsible for ensuring compliance with the risk retention requirement by at least one sponsor.[6]

The definition of "securitizer" in Section 15G also includes an issuer of ABS. For purposes of the federal securities laws, an "issuer" of ABS generally means the depositor (*i.e.*, the entity that deposits the pool assets with the issuing entity).[7] However, the Agencies have chosen to apply the risk retention requirements to the sponsor rather than the depositor.

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[3] The Agencies interpret "issuer" for this purpose as referring to the issuing entity.

[4] *See* Item 1101 of Regulation AB.

[5] The NPR states that "in the context of collateralized loan obligations (CLOs), the CLO manager generally acts as the sponsor by selecting the commercial loans to be purchased by an agent bank for inclusion in the CLO collateral pool, and then manages the securitized assets once deposited in the CLO structure."

[6] While not altogether clear, the proposed rules do not appear to permit the sponsors to allocate the required risk retention among themselves, but would require at least one of them to retain all of the required interest. In the NPR, the Agencies request comment on whether this is the best approach or whether the required retention should be permitted to be allocated among multiple sponsors in some other way.

[7] *See*, *e.g.*, Rule 191 under the Securities Act of 1933, as amended (the "Securities Act") and Rule 3b-19 under the Exchange Act.

Originators

The proposed rules do not require that any originator retain credit risk associated with securitized assets.[8] However, the proposed rules permit a sponsor (with the agreement of the affected originators) to allocate some or all of its risk retention obligations to one or more originators of the securitized assets. "Originator" is defined in Section 15G of the Exchange Act as any entity that "creates" a securitized financial asset and sells that asset directly or indirectly to a securitizer. Under the Agencies' interpretation, only the original creditor under the financial asset is an originator for this purpose, so the required risk retention could not be allocated to any subsequent purchaser or transferee.[9] The sponsor's risk retention requirements would be offset by any amount allocated to an originator.

The sponsor would only be permitted to allocate risk retention to an originator that contributes at least 20 percent of the assets to the pool in question, and the originator would be required to hold a percentage of the retention interest of at least 20 percent, but no more than the percentage of the pool assets it originated. An originator to which any risk retention is allocated would be subject to the same restrictions as the sponsor with respect to transferring, hedging, and financing its retained interest, as described below.

This risk allocation option would be available only if the vertical or horizontal risk retention methods are used. Each party that retains risk in a transaction would be required to use the same retention method, and the originator would be required to acquire the economic interests either for cash or by virtue of a reduction in the price paid by the sponsor or depositor for the related assets.

Sponsors that allocate risk retention to originators would remain responsible for compliance with the rules regarding retained credit risk, would be required to monitor the compliance by each originator, and would be required to notify securityholders upon discovery of any noncompliance by originators.

CMBS B-Piece Buyers

As described below, in a commercial mortgage-backed securities ("CMBS") transaction, the proposed rules would permit the sponsor of a CMBS transaction to meet its risk retention requirements if a third-party buyer acquires the B-piece, provided that a variety of conditions are met.

ABCP Originator-Sellers

As described below, the proposed rules would permit an asset-backed commercial paper ("ABCP") conduit vehicle to meet its risk retention requirements if each originator-seller that transfers assets to collateralize the ABCP retains certain credit risks.

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[8] The Agencies expressed concern that requiring originators such as mortgage brokers and small community banks to retain credit risk could adversely impact credit availability because those parties would have difficulty obtaining funding for any such risk retention. The Agencies said risk retention at that level could cause operational and compliance problems because "a loan may be sold or transferred several times between origination and securitization and . . . an originator may not know when a loan it has originated is included in a securitization transaction."

[9] Regulation AB uses the term "originator" but does not define it. In a correspondent lending arrangement in which a lender originates loans pursuant to a purchaser's underwriting guidelines and the purchaser has previously committed to purchase loans that satisfy its guidelines, ABS market participants generally have viewed the purchaser, not the correspondent lender, as the originator for purposes of Regulation AB. Under the risk retention rules as proposed, the original creditor would be the originator, but it is not entirely clear whether the SEC and the Banking Agencies intend to prohibit a party that purchases loans from a correspondent lender from sharing a sponsor's risk retention obligation.

Resecuritization Sponsors

Only single-class pass-through resecuritizations of underlying ABS for which the risk retention requirements were satisfied would be exempt from the risk retention requirements of the proposed rules, as discussed below. However, the sponsor of any other type of resecuritization, including a transaction in which sponsors of the underlying ABS have complied with applicable risk retention requirements but more than one class of securities is issued in the resecuritization, would be required to comply with the risk retention requirements.

Permitted Forms of Risk Retention

Base Risk Retention Requirement

The proposed rules would apply to securitizers in issuances of "asset-backed securities" as newly defined in the Exchange Act, as amended by the Dodd-Frank Act.[10] This new category of ABS encompasses a much broader range of instruments than asset-backed securities as defined in Regulation AB, including all securities that are collateralized[11] by self-liquidating financial assets that allow securityholders to receive payments based primarily on the cash flows from those assets, whether offered publicly or privately. Among other things, ABS for these purposes include collateralized debt obligations, securities issued or guaranteed by a government sponsored entity such as Fannie Mae or Freddie Mac, municipal ABS and any security that the Commission, by rule, determines to be an asset-backed security.

So-called "synthetic" securitizations, such as transactions effectuated through the use of credit default swaps, total return swaps or other derivatives, would not be covered by the proposed rules, although the scope of this exclusion is unclear.[12]

Section 15G generally requires that a securitizer retain not less than 5 percent of the credit risk for any asset that the securitizer, through the issuance of ABS, transfers, sells, or conveys to a third party, unless an exemption is available. Therefore, the base risk retention requirement of the proposed rules is that the sponsor retain an economic interest equal to at least 5 percent of the aggregate credit risk of the pool assets. The base risk retention requirement would be a minimum, and sponsors, originators and other transaction parties could retain additional credit risk exposure.

The proposed rules would permit the risk retention requirement to be satisfied through several methods that attempt to recognize the diversity of asset classes and securitization structures. In general, no particular method is mandated, though the Agencies request comment on whether certain methods should be mandated for particular asset classes or securitization structures. For each method, the proposed rules

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[10] *See* Section 3(a)(77) of the Exchange Act.

[11] The proposed rules clarify that the term "collateralize," as used in Section 15G and in the proposed rules, does not imply any specific legal structure for a securitization covered by the risk retention requirements. "Assets or other property collateralize an issuance of ABS interests if the assets or property serve as collateral for such issuance." Assets or other property serve as collateral for an ABS issuance if they "provide the cash flow (including cash flow from the foreclosure or sale of the assets or property) for the ABS interests irrespective of the legal structure of issuance, including security interests in assets or other property of the issuing entity, fractional undivided property interests in the assets or other property of the issuing entity, or any other property interest in such assets or other property."

[12] The NPR states that because the term "asset-backed security" for purposes of Section 15G includes only those securities that are collateralized by self-liquidating financial assets, "synthetic" securitizations are not within the scope of the proposed rules.

prescribe disclosure requirements designed to make clear to investors, the SEC and any applicable federal banking agency how credit risk associated with the transaction is retained.

Vertical Retention by Sponsor

A sponsor could satisfy its obligation by retaining at least 5 percent of each class of "ABS interests" issued as part of the securitization transaction. The vertical risk retention option would give the sponsor an interest in the entire structure of the securitization transaction.

For purposes of the proposed rules, an "ABS interest" includes all types of interests issued by an issuing entity, whether or not certificated, including any security, obligation, beneficial interest or residual interest, the payments on which primarily depend on the cash flows from the pool assets.[13] While the proposed rules do not specify how the amount of each class of ABS interests is to be measured, the NPR states that, regardless of method of measurement, the retained credit risk should equal at least 5 percent of the par value (if any), fair value, and number of shares or units of each class.[14]

Horizontal Retention by Sponsor

Eligible horizontal residual interest. A sponsor could satisfy its risk retention obligations by retaining an "eligible horizontal residual interest" in the issuing entity in an amount equal to at least 5 percent of the par value of all ABS interests issued as part of a securitization transaction. The horizontal risk retention option would expose the sponsor to a first loss position with respect to the entire asset pool.

In an effort to ensure that an eligible horizontal residual interest remains in a first loss position, available to absorb losses on the pool assets, the proposed rules impose conditions that are not typical of current transaction structures. An eligible horizontal residual interest:

- must be allocated all losses on the asset pool until its par value is reduced to zero;
- must have the most subordinated claim to payments of both principal and interest by the issuing entity; and
- may receive its *pro rata* share of scheduled principal payments in accordance with the transaction documents, but generally cannot receive any other payments of principal on a pool asset (*i.e.,* unscheduled principal payments) until all other ABS interests in the issuing entity are paid in full, so that unscheduled payments will not accelerate the payoff of the horizontal residual interest before any other ABS interest.

It appears that an excess spread residual interest that is not entitled to distributions of principal would not satisfy these criteria. Distributions of interest on a fully subordinated basis on an eligible horizontal residual interest appear to be permitted without restriction.

Horizontal cash reserve account. The proposed rules also would allow a sponsor to establish and fund a cash reserve account referred to as a "horizontal cash reserve account" in lieu of retaining an eligible

[13] The term excludes common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests in an issuing entity that are issued primarily to evidence ownership of the issuing entity and the payments on which are not primarily dependent on the cash flows of the underlying assets.

[14] Neither "par value" nor "fair value" is defined in the proposed rules. "Par value" generally refers to the face amount, stated value or nominal dollar value of a security.

horizontal residual interest. Similar to an eligible horizontal residual interest, the amount in the account would have to equal at least 5 percent of the par value of all the ABS interests issued as part of the transaction. The account would be held by the trustee for the benefit of the issuing entity, and could only be invested in U.S. Treasury bills or FDIC-insured deposits.

The proposed rules impose various conditions on a horizontal cash reserve account in an effort to ensure that such an account would be exposed to the same credit risk as a sponsor holding an eligible horizontal residual interest. The horizontal cash reserve account must:

- be used to satisfy payments on ABS interests when the issuing entity otherwise would have insufficient funds; and

- provide that no amounts may be released or withdrawn from the account until all ABS interests in the issuing entity are paid in full or the issuing entity is dissolved, with only two exceptions:

  - amounts may be released due to receipt of scheduled principal payments on the pool assets, if the issuing entity distributes them in accordance with the transaction documents and only on a *pro rata* basis; and

  - the sponsor could receive interest income on the permitted investments in the account.

L-Shaped Retention by Sponsor

A sponsor could satisfy its risk retention obligations by using the “L-shaped” method, meaning an equal combination of vertical and horizontal risk retention. The proposed rules would require that the sponsor retain at least 2.5 percent of each class of ABS interests issued in the securitization transaction, as well as an eligible horizontal residual interest equal to at least 2.564 percent of the par value of all ABS interests issued in the securitization transaction, other than those required to be retained as part of the vertical component (or an equivalent horizontal cash reserve account). The amount of the horizontal component avoids double-counting the portion of an eligible horizontal residual interest that the sponsor must hold as part of the vertical component, and ensures that the combined amount equals 5 percent of the ABS interests.

Retention by Sponsor of Representative Sample

A sponsor could satisfy its risk retention obligations by retaining a randomly selected representative sample of assets that is materially equivalent to the pool assets. The representative sample option is intended to expose the sponsor to substantially the same type of credit risk as investors in the ABS. Under this option, the unpaid principal balance of all the assets in the representative sample would be required to equal at least 5 percent of the aggregate unpaid principal balance of all the assets initially identified for inclusion in the pool, including those that end up in the representative sample (or 5.264 percent of the total principal balance of the securitized pool). The requirements that have been proposed in an effort to ensure that the sponsor remains exposed to substantially the same aggregate credit risks as investors in the ABS are numerous and complex, and appear to be designed to accommodate only some asset classes.

The proposed rules prescribe several requirements to satisfy this method of retaining credit risk. The sponsor would be required to:

- designate a pool of at least 1,000 separate assets;[15]

- randomly select the representative sample from that designated pool;

- ultimately securitize or retain (as part of the representative sample) all assets in the designated pool;[16] and

- assess the sample to ensure that for each "material characteristic"[17] of the assets the mean of any quantitative characteristic, and the proportion of any characteristic that is categorical in nature, of the assets in the representative sample is within a "95 percent two-tailed confidence interval"[18] of the mean or proportion of the same characteristic of all the assets in the designated pool.

According to the NPR, if the sample fails this statistical test, the selection process must start over or another risk retention option must be chosen.

The proposed rules require the sponsor to establish and adhere to policies and procedures for:

- identifying and documenting the material characteristics of the assets in the designated pool;

- selecting assets for the random sample;

- testing the assets in the random sample;

- maintaining documentation identifying the assets in the representative sample; and

- prohibiting assets in the representative sample from being included in a designated pool for any other securitization.

Before selling the ABS, the sponsor would be required to obtain an agreed-upon procedures report from an independent public accounting firm addressing whether the sponsor has established these policies and procedures. An acceptable agreed-upon procedures report may be relied upon for subsequent securitizations, unless the sponsor's policies and procedures have changed in any material respect.

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[15] It is not clear to what extent the Agencies have considered the implications for securitization of certain asset types, such as residential and small balance commercial mortgage loans, of requiring that at least 1,000 assets be designated. Use of the representative sample method of risk retention would probably not be feasible for some transactions, such as collateralized loan obligations, securitizations of large balance commercial loans or resecuritizations, even in the absence of this requirement.

[16] In other words, if any assets are removed from the designated pool for any reason prior to the securitization, such removal must occur before the final identification of the designated pool.

[17] According to the NPR, the unpaid principal balance of an asset is always a material characteristic. Other material characteristics are not defined, but they may include the location of the property securing the loan, the debt-to-income ratio(s) of the borrower, and the interest rate.

[18] This statistical term is not defined in the proposed rules. In general, a "confidence interval" describes the degree of uncertainty associated with a sampling method. The term is used in various federal regulations; the federal banking regulators have referred to confidence intervals in aspects of risk-based capital guidelines for banks and thrifts. In a recent rule proposal, the National Credit Union Administration stated that "[c]onfidence levels and confidence intervals are statistical concepts that relate to the precision of the estimates produced by the sampling approach. Confidence level is the probability that the results of a sampling approach are within the confidence interval of the true answer. Confidence interval specifies the allowable margin of error around the true answer." Sample Income Data To Meet the Low-Income Definition, 75 Fed. Reg. 80,364, at fn. 4 (Dec. 22, 2010).

Until all ABS interests in the issuing entity have been fully paid or the issuing entity has been dissolved, the assets in the representative sample must be serviced by the same servicer and under the same standards as the securitized assets.[19] The proposed rules also state that the individuals responsible for servicing the assets must not be able to determine whether an asset is held by the sponsor or the issuing entity.[20]

The sponsor would be prohibited from removing any assets from the representative sample and, until all ABS interests are repaid, from permitting the assets in the representative sample to be included in any other designated pool or representative sample for any other securitization.

As further described below, detailed, separate disclosure regarding the securitized assets and the retained assets would be required at the time of the ABS offering and on an ongoing basis.

It is not clear what the consequences would be for a sponsor or its securitizations if the ongoing requirements for servicing and segregation of the representative sample and for investor disclosure were not satisfied.

Horizontal Retention by CMBS B-Piece Buyer

Transfer to third-party buyer. Section 15G authorizes the Agencies to permit the retention of the "B-piece" of a CMBS transaction by a third party "B-piece buyer," rather than the sponsor, to satisfy the Dodd-Frank Act's risk retention requirements. The proposed rules would permit the sponsor of a CMBS transaction[21] to meet its risk retention requirements if a third-party B-piece buyer acquires an eligible horizontal residual interest, provided that several conditions are satisfied:

- the eligible horizontal residual interest must be acquired and retained by the B-piece buyer in the same form, amount, and manner as would be required of the sponsor under the horizontal risk retention option;
- the B-piece buyer must pay for the B-piece in cash at closing, without financing received directly or indirectly from any other transaction party other than an investor;
- the B-piece buyer must perform a due diligence review of the credit risk of each asset in the pool, including a review of the underwriting standards, collateral, and expected cash flows of each loan; and
- neither the B-piece buyer nor any affiliate generally may have any control rights (including servicing and special servicing) not shared with other investors, except as described below.

Control rights. As is noted in the NPR, in CMBS transactions the B-piece buyer is often the holder of the "controlling class" and is, or is affiliated with, the special servicer, but control of the special servicing function by the holder of a subordinate interest has the potential to create conflicts of interest with holders of senior securities.

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[19] As a result, this method of risk retention would probably not be feasible if an issuing entity's assets are serviced by multiple servicers.
[20] It is not clear how this requirement could be fulfilled in practice, in view of the typical servicer's responsibility for collecting and remitting payments on the pool assets. It would of course be necessary to ensure that cash flows on the securitized assets are properly remitted to securityholders and that cash flows on the retained assets are properly remitted to the sponsor.
[21] At least 95 percent of the total unpaid principal balance of the securitized assets must be commercial real estate loans.

Under the proposed rules, the B-piece buyer could not be affiliated with any other transaction party other than an investor[22] or have any control rights (including servicing or special servicing) not shared by all other investors unless the transaction documents provide for an independent operating advisor that is not affiliated with any other transaction party, does not have any direct or indirect financial interest in the securitization other than its fees, and is required to act in the best interest of all investors.

The B-piece buyer or an affiliate would be permitted to act as servicer or special servicer, or to have control rights related to servicing, if the operating advisor has certain powers and duties, and if the B-piece buyer or any affiliate (when acting as a servicer) consults with the operating advisor before any major servicing decision (such as any material modification or waiver of any provision of a loan agreement, and any foreclosure on or acquisition of property). The transaction documents would be required to make the operating advisor responsible for reviewing the actions of the B-piece buyer or any affiliate (when acting as servicer) and for issuing a periodic report concerning its belief (in its sole discretion, exercised in good faith) as to whether that servicer is in compliance with the applicable servicing standards.

In addition, the transaction documents would be required to provide that the operating advisor has the authority to recommend that the B-piece buyer or any affiliate (when acting as a servicer) be replaced as servicer if the operating advisor determines (in its sole discretion, exercised in good faith) that the B-piece buyer or affiliate failed to comply with any applicable servicing standard and that its replacement would be in the best interest of all investors. If the operating advisor makes such a recommendation the servicer or special servicer must be replaced absent the consent of a majority of each class of certificateholders.

<u>Hedging prohibition</u>. The B-piece buyer would be subject to the same restrictions as the sponsor with respect to transferring, hedging, and financing the retained interest under the horizontal risk retention option.

<u>Duty to comply</u>. If a B-piece buyer holds the credit risk, the sponsor would remain responsible for compliance with all of the relevant risk retention requirements, and would be required to implement and adhere to policies and procedures to monitor the B-piece buyer's compliance. If the sponsor discovers any noncompliance, it would be required to promptly notify investors.

Retention by Sponsor of Seller's Interest in Revolving Asset Master Trust

A revolving asset master trust structure often is used to securitize revolving receivables such as credit card accounts or dealer floorplan loans. In this structure, which allows a trust to issue more than one series of ABS backed by the same revolving asset pool, the sponsor typically holds a "seller's interest" in the asset pool that is *pari passu* with the ABS interests sold to investors until the occurrence of an early amortization event.[23] The seller's interest adjusts for fluctuations in the outstanding principal balances of the securitized assets. The sponsor of a revolving master trust could satisfy its risk retention obligations by retaining a seller's interest in an amount not less than 5 percent of the unpaid principal balance of all the assets held by the issuing entity. The seller's interest option would expose the sponsor to the credit risk of the full asset pool, the same risk to which the holders of the ABS are subject.

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[22] This requirement is subject to a *de minimis* exception permitting affiliation with one or more originators of the securitized assets collectively comprising less than 10 percent of the pool's dollar volume.
[23] The proposed rules would also require that the seller's interest represent an interest in assets that "do not collateralize other ABS interests issued by the issuing entity."

Retention by Originator-Sellers of Residual Interests in ABCP Conduit Vehicles

The proposed rules would permit the sponsor of an ABCP conduit vehicle to meet its risk retention requirements if each originator-seller that transfers assets to collateralize the ABCP retains certain credit risks. This option would be available only for ABCP having a maturity of nine months or less that is collateralized by receivables or loans and supported by a liquidity facility that provides 100 percent liquidity coverage from a regulated institution, and thus would be unavailable for ABCP programs that operate as securities or arbitrage programs.

In both single-seller and multi-seller ABCP programs, the sponsor approves the originator-sellers whose loans or receivables will collateralize the conduit's ABCP. An approved originator-seller then sells eligible loans or receivables to an intermediate, bankruptcy remote special purpose vehicle (an "SPV"). The credit risk of these receivables is separated into a senior interest that is purchased by the ABCP conduit, and a residual interest that absorbs first losses and is retained by the originator-seller. The short-term ABCP issued by the conduit is collateralized by the senior interests purchased from the intermediate SPVs, which are supported by the retained residual interests. The sponsor, which usually is a bank or other financial institution, typically provides or arranges for 100 percent liquidity coverage on the ABCP, which requires the support provider to fund the repayment of maturing ABCP if the conduit lacks the required funds.

<u>Eligible ABCP conduit</u>. This risk retention option would be available only with respect to ABCP issued by an "eligible ABCP conduit," which must meet several requirements:

- the issuing entity must be bankruptcy remote from the sponsor and any intermediate SPV;
- the ABS issued by an intermediate SPV must be collateralized solely by assets originated by a single originator-seller;
- all the interests issued by an intermediate SPV must be transferred to one or more ABCP conduits or retained by the originator-seller; and
- a regulated liquidity provider must have committed to provide 100 percent liquidity coverage on the ABCP.

If these requirements are met, the sponsor of an eligible ABCP conduit would be permitted to satisfy its base risk retention obligations if each originator-seller to the conduit retains the same amount and type of credit risk as would be required under the horizontal risk retention option if the originator-seller was the sponsor of the intermediate SPV, *i.e.*, an eligible horizontal residual interest in each intermediate SPV equal to at least 5 percent of the par value of all interests issued by the intermediate SPV. This eligible horizontal residual interest would be subject to the same terms and conditions that apply to a sponsor under the horizontal risk retention option.

The proposed rules do not appear to contemplate structures in which interests issued by intermediate SPVs that are subordinate to the ABS interests sold to ABCP conduits but senior to the residual interest are sold to third parties.

ABCP sponsors that satisfy their risk retention obligation through this method would be required to disclose to investors the identity of each originator-seller that retains a residual interest, which is not common practice for ABCP conduits, and each liquidity provider.

<u>Duty to comply</u>. Certain obligations would be imposed directly on the sponsor, including requirements that that the sponsor remain responsible for the originator-sellers' compliance and that the sponsor maintain policies and procedures to monitor that compliance. If the sponsor determines that an originator-seller is noncompliant, the sponsor would be required to promptly notify investors. The proposed rules also would require that the sponsor establish the eligible ABCP conduit, approve its originator-sellers, establish criteria governing the assets that the originator-sellers may sell to an intermediate SPV, approve all intermediate SPV interests to be purchased by the conduit, administer the conduit, and establish and maintain policies and procedures for ensuring that the requirements of the rule are met.

No Additional Risk Retention for ABS Guaranteed by Fannie Mae or Freddie Mac

The proposed rules contain special provisions regarding credit risk retention requirements for Fannie Mae and Freddie Mac (the "GSEs") while operating under the conservatorship or receivership of the Federal Housing Finance Agency (the "FHFA"), and certain successors to a GSE.

The GSEs fully guarantee the timely payment of principal and interest on their mortgage-backed securities, so they are exposed to the entire credit risk of the underlying mortgage loans. The proposed rules provide that the guarantee of a GSE while operating under the conservatorship or receivership of FHFA with capital support from the United States (and an equivalent guarantee by a successor also operating under the direction and control of FHFA with capital support from the United States) will satisfy the risk retention requirements of Section 15G. Neither the premium capture cash reserve account requirements nor the hedging and financing prohibitions described below would apply to a GSE or its successor.[24]

The NPR notes that the Obama administration and Congress have been considering a variety of proposals to reform the housing finance system and the GSEs, and that the Agencies expect to revisit these provisions after the future of the GSEs becomes clearer. In the short time since publication of the proposed rules by the Agencies, some Republicans and Democrats in Congress have expressed opposition to the exemption of the GSEs from the risk retention requirements of Section 15G.[25]

Premium Capture Cash Reserve Account

Securitizers that already are subject to the base credit risk retention requirement also could be subject to an additional risk retention requirement if they seek to monetize excess spread.

In the NPR, the Agencies explain that "in many securitization transactions, particularly those involving residential and commercial mortgages, conducted prior to the financial crisis, sponsors sold premium or interest-only tranches in the issuing entity to investors, as well as more traditional obligations that paid both principal and interest received on the underlying assets. By selling premium or interest-only tranches, sponsors could thereby monetize at the inception of a securitization transaction the 'excess spread' that was expected to be generated by the securitized assets over time." The Agencies define "excess spread" as "the difference between the gross yield on the pool of securitized assets less the cost of financing those

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[24] So long as the GSE or its successor is operating under the conservatorship or receivership of FHFA with capital support from the United States.

[25] Rep. Scott Garrett (R., N.J.) has introduced the "GSE Credit Risk Equitable Treatment Act," which is intended to "ensure mortgages held or securitized by Fannie Mae and Freddie Mac and asset-backed securities issued by such enterprises are treated similarly as other mortgages and asset-backed securities for purposes of the credit risk retention requirements." The bill, if enacted, would override any final rules exempting the GSEs from the risk retention requirements. Rep. Barney Frank (D., Mass.), the ranking Democrat on the House Financial Services Committee, has publicly stated that he favors passage of similar legislation.

assets (weighted average coupon paid on the investor certificates), charge-offs, servicing costs, and any other trust expenses (such as insurance premiums, if any)." By monetizing excess spread before the performance of the securitized assets could be observed and unexpected losses realized, the Agencies say, "sponsors were able to reduce the impact of any economic interest they may have retained in the outcome of the transaction and in the credit quality of the assets they securitized. This created incentives to maximize securitization scale and complexity, and encouraged aggressive underwriting."

In order to "achieve the goals of risk retention," the Agencies propose to capture the premium received on the sale of ABS that monetize the excess spread by requiring that this amount be used to fund a "premium capture cash reserve account" that would bear losses before any class of ABS, including an eligible horizontal residual interest. Otherwise, according to the Agencies, "a sponsor could effectively negate or reduce the economic exposure it is required to retain under the proposed rules" through monetization of excess spread.[26] The Agencies state bluntly in the NPR that as a result of the premium capture requirement they "expect that few, if any securitizations would be structured to monetize excess spread at closing."

The premium capture cash reserve account would be required to be funded at closing in an amount (if any) by which:

- the gross proceeds (net of closing costs paid to unaffiliated parties) from the sale of ABS interests to parties unaffiliated with the sponsor

exceed

- 95 percent of the par value of the issuing entity's ABS interests (if credit risk is retained in vertical, horizontal or L-shaped form or as a seller's interest in a revolving asset master trust) or 100 percent of the par value of the issuing entity's ABS interests (if credit risk is retained in the form of a representative sample of securitized assets, by ABCP originator-sellers or by a CMBS B-piece buyer).

The reserve account would be held by the trustee for the issuing entity, and could only be invested in U.S. Treasury bills or FDIC-insured deposits. Other than investment income, amounts in the reserve account could (until all ABS interests have been paid in full or the trust is terminated) be released only to make required payments on ABS interests when the issuing entity has insufficient funds to do so. The determination of whether the issuing entity has sufficient funds must be made before allocation of any losses to an eligible horizontal interest held under the horizontal, L-shaped, ABCP or CMBS B-piece options or (if risk retention is satisfied by retention of a vertical slice, seller's interest or representative sample) before allocation of losses to the class of ABS interests that is in the first loss position or has the most subordinate claim to payment of principal or interest.

An anti-evasion provision would require that gross proceeds be increased by the par value or fair value of any ABS interest transferred to the sponsor, if the sponsor does not intend to hold that ABS interest to maturity or if that ABS interest represents a right to receive "some or all of the interest and no more than a minimal amount of principal payments" and is senior to the most subordinated class. The anti-evasion

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[26] The NPR states that prohibiting sponsors from receiving compensation in advance for excess spread income expected to be generated by securitized assets over time "should better align the interests of sponsors and investors and promote more robust monitoring by the sponsor of the credit risk of securitized assets, thereby encouraging the use of sound underwriting in connection with securitized loans." Further, the Agencies say, this prohibition "should promote simpler and more coherent securitization structures."

provision would not apply to required risk retained in the form of a vertical slice (or the vertical portion of L-shaped retention) if the retained interest does not have a par value.

Sponsors would be required to disclose to investors the amount deposited in the premium capture cash reserve account and the material assumptions and methodology used to determine the fair value of any ABS interest not having a par value that was retained by the sponsor.

Qualified Assets

Section 15G of the Exchange Act exempts from the risk retention requirements any ABS collateralized solely by QRMs. Section 15G also directs the Agencies to define jointly what constitutes a QRM, "taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default." In addition, Section 15G directs the SEC and the Banking Agencies to adopt separate risk retention rules for ABS backed by commercial real estate loans ("CRE loans"), other commercial loans, auto loans, and any other asset class that they deem appropriate, providing for retention of less than 5 percent credit risk if the loans satisfy underwriting standards developed by the Banking Agencies that indicate low credit risk. The Agencies refer to QRMs and CRE loans, other commercial loans and auto loans that satisfy the criteria for exemption from the credit risk retention requirement as "qualified assets."

Qualified Residential Mortgages

ABS would be exempt from the risk retention requirement if:

- every loan in the related securitized pool is a QRM – and not a class of ABS backed by QRMs (or other assets);
- every loan in the pool currently is less than 30 days delinquent in payment;[27] and
- the depositor certifies that "it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the asset-backed security are qualified residential mortgages and has concluded that its internal supervisory controls are effective."

These "internal supervisory controls" must be evaluated for each issuance of ABS relying on the QRM exemption within 60 days prior to the related cut-off date, and a copy of the depositor's certification must be delivered to prospective investors and, upon request, to the Commission and any applicable banking regulator.

As proposed, the requirements for satisfaction of the definition of "qualified residential mortgage" are extensive and strict, as they are intended to ensure that these loans are "of very high credit quality." As stated in the NPR, "[t]he Agencies recognize that many prudently underwritten residential mortgage loans will not meet the proposed definition of a QRM."

The proposed QRM standards address loan characteristics, credit underwriting, servicing and disclosure. The NPR states that the Agencies have sought to make these standards "transparent" and "verifiable." For example, many definitions and terms have been adapted from those used in underwriting standards applicable to loans insured by the Federal Housing Administration. However, it is not clear that compliance with all of the proposed QRM standards would be readily verifiable by a securitizer.

[27] As written, this requirement appears to apply as of the closing date, not the cut-off date.

Definition. The proposed rules would define "QRM" as a closed-end loan made to purchase or refinance a one- to four-family property, if at least one unit is the principal residence of a borrower and the loan:

- is not :
    - a loan to finance initial construction;
    - a reverse mortgage loan;
    - a temporary or bridge loan with a term of one year or less; or
    - a timeshare plan; and
- satisfies the eligibility criteria described below.

Eligibility. In order to qualify as a QRM, a mortgage loan would be required to satisfy each of the criteria described below, among others.

First lien. The loan must be secured by a perfected first lien on the mortgaged property.

Limitations on subordinate liens. For a loan to purchase a property, there must be no other recorded or perfected liens on the mortgaged property, to the creditor's knowledge, at the time of closing of the loan. The proposed rules would not prohibit subordinate liens in connection with the refinancing of a first lien loan, provided that the combined loan-to-value ratio ("LTV") does not exceed the applicable thresholds described below.

Maximum maturity. The term of the loan must not exceed 30 years.

Borrower's credit history.[28] The creditor must, within 90 days prior to the closing of the loan transaction, verify that the borrower:

- is not currently 30 or more days delinquent in payment on *any* debt;
- has not been 60 or more days delinquent on *any* debt in the previous two years; and
- has not been in bankruptcy or had any property repossessed, foreclosed on or subject to a short sale in the previous three years.[29]

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[28] The Agencies elected not to use a borrower's credit score as a criterion for QRM eligibility because various credit scoring models may be inconsistent and models may change over time. Instead, the Agencies chose to define a set of so-called "derogatory factors" that would disqualify a borrower's mortgage loan from qualifying as a QRM. These factors are "designed to be a reasonable proxy" for credit score thresholds associated with low delinquency rates. The Agencies cite a report by the Board of Governors of the Federal Reserve System showing that the median FICO score is "somewhere between 700 and 749," and that "borrowers with prime fixed-rate mortgages with FICO scores below 700 were substantially more likely" to default than the average of prime fixed rate borrowers. That report concludes that "any major derogatory factor, including being substantially late on any debt payment (not just a mortgage), as well as bankruptcy or foreclosure, would push a borrower's credit score down substantially."

[29] The NPR states that "[t]he Agencies' own analysis, as well as work published in academic journals, indicates that borrower credit history is among the most important predictors of default."

The creditor would be deemed to have satisfied these requirements if it obtains at least two credit reports obtained no more than 90 days before the loan closing confirming the above, provided that no subsequent credit report obtained by the creditor before the loan closing contains contrary information.

Payment terms. The loan must not provide for negative amortization, balloon payments, interest-only payments, optional deferral of payments or increases in interest rate or scheduled payments above specified limits,[30] and may not impose a prepayment penalty.

Points and fees. Total points and fees payable by the borrower may not exceed 3 percent of the loan amount.

Borrower debt-to-income ratio. The creditor must verify and document the borrower's income in accordance with specified standards, and determine that as of a date no more than 60 days prior to the closing of the loan transaction the ratio of the borrower's total housing debt[31] (including any other mortgage loans, if the QRM is for refinancing, as well as related taxes, insurance premiums, dues, and other assessments) to gross income does not exceed 28 percent, and the ratio of the borrower's total monthly debt to gross income does not exceed 36 percent.

Loan-to-value ratio. For a loan to purchase a property, the LTV may not exceed 80 percent. The maximum combined LTV is 75 percent for a rate and term refinancing, and 70 percent for a cash-out refinancing. Mortgage insurance could not be considered in calculating the LTV.

Down payment. The borrower must pay at closing, solely from acceptable sources of "borrower funds":

- a down payment equal to 20 percent of the lesser of the appraised value of the mortgaged property and, in the case of a purchase financing, the purchase price, plus

- any closing costs payable by the borrower, plus

- in the case of a purchase financing, any amount by which the purchase price exceeds the appraised value.

Loss mitigation. The loan documents themselves, not merely any related servicing agreement, must include the creditor's commitment to:[32]

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[30] Interest rates on adjustable rate mortgage loans could not increase by more than 2 percent in any twelve month period, or by more than 6 percent over the life of the loan.

[31] For this purpose, calculation of interest payments on loans would be based on the maximum interest rate that could be charged during the first five years of the loan's term.

[32] The Agencies call attention in the NPR to the fact that that there is currently an interagency effort among certain Federal regulatory agencies, including some of the Agencies joining in the proposed rulemaking, to develop national mortgage servicing standards that would apply to all servicers of residential mortgage loans. These standards would apply to residential mortgage loans regardless of whether the mortgage loans are QRMs, are securitized or are held in portfolio by a financial institution. The NPR states that the primary objective of this separate interagency effort is to develop a "comprehensive, consistent, and enforceable set of servicing standards for residential mortgages that servicers would have to meet." The Agencies say that they anticipate requesting comment on proposed servicing standards later this year, with the goal of issuing final standards shortly afterward.

- undertake within 90 days following an uncured delinquency, loss mitigation activities, such as a loan modification or alternative loss mitigation if the net present value of the proceeds realized by such action would exceed the net present value of a recovery through foreclosure;

- take into account the borrower's ability to repay and "other appropriate underwriting criteria" in any such loss mitigation activities;

- implement unspecified servicing compensation arrangements that are consistent with the loss mitigation commitment;

- implement procedures for "addressing" any loan owned by the creditor and secured by a subordinate lien on the mortgaged property, and disclose these procedures to investors if the QRM is included in a securitized pool; and

- not transfer servicing rights unless the purchaser or successor servicer agrees to abide by the creditor's loss mitigation commitments.[33]

QRMs may not be assumable.

<u>Preservation of exemption</u>*.* If after the closing of a securitization it is discovered that one or more securitized loans does not satisfy all of the QRM criteria, the sponsor would not lose its exemption from the risk retention requirement if:

- the depositor complied with the certification requirement described above;

- within 90 days of discovery of the noncompliance, the sponsor repurchases all affected loans from the trust for a price equal to not less than the unpaid principal balance plus accrued interest; and

- the sponsor promptly notifies securityholders of the noncompliance and the repurchase.

Possible Alternative Approach to the QRM Exemption

The Agencies request comment on an approach to the QRM exemption that would create a broader definition of a QRM that would include mortgage loans of potentially lower credit quality, but would also impose stricter risk retention requirements for securitizations of residential mortgage loans that do not qualify as QRMs, in an effort to incentivize origination of QRMs. Under this alternative, sponsors could be required to retain more than 5 percent credit risk on securitized pools of non-QRM residential mortgage loans, or could be limited only to vertical risk retention or another specific retention method. The QRM requirements could be modified, in an example provided by the Agencies, as follows:

- for a purchase transaction or a rate and term refinancing, the combined LTV could not exceed 90 percent, and for a cash-out refinancing, the combined LTV could not exceed 75 percent;

- there would be no restriction on subordinate liens;

- the down payment for a purchase could be as low as 10 percent plus any closing costs payable by the borrower;

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[33] Although this provision refers to transfer of "servicing rights," it is not clear whether it is intended to address a transfer of servicing responsibility in which servicing rights are not transferred.

- higher debt-to-income ratios would be permitted; and
- mortgage insurance could be considered in determining whether the applicable LTV requirement has been satisfied.

Other Qualified Assets

The proposed rules include underwriting standards for CRE loans, commercial loans, and consumer automobile loans and would completely exempt ABS backed by qualifying assets from the risk retention requirements.

No underwriting standards were proposed for residential mortgage loans other than those that would qualify as QRMs. Although Section 15G authorized the Commission and the Banking Agencies to develop underwriting standards for non-QRM qualified assets that would be subject to a credit risk retention requirement of "less than 5 percent," the Agencies chose only to propose standards consistent with a complete exemption from the risk retention requirement. The Agencies expressed concern that a risk retention level between zero and 5 percent may not provide sufficient incentive for securitizers to allocate the resources necessary to ensure that the loans would satisfy the required underwriting standards. Section 15G also authorized the identification of additional asset classes that could be subject to a lower credit risk retention requirement, but the Commission and the Banking Agencies chose not to exercise this authority.[34]

Qualifying commercial loans. The proposed rules define "commercial loan" to mean any secured or unsecured loan to a company or an individual for business purposes, other than a loan to purchase or refinance a one- to-four family residential property, a loan for the purpose of financing agricultural production, or a loan for which the primary source (*i.e.*, 50 percent or more) of repayment is expected to be derived from rents collected from non-affiliates of the borrower. A qualifying commercial loan would be required to meet the following requirements:

- the creditor must verify the borrower's ability to repay its obligations by taking specified steps, including verifying and documenting the borrower's financial condition as of the two most recent fiscal years, and analyzing the borrower's ability to service its debts during the next two years, based on compliance with a total liabilities ratio of 50 percent or less, a leverage ratio of 3.0 or less, and a debt service coverage ("DSC") ratio of 1.5 or greater;
- the loan payments must be based on straight-line amortization not exceeding five years from the closing date;
- payments must be required at least quarterly for a term not exceeding five years;
- if the loan is collateralized, the collateral must be subject to a first lien security interest and the documentation must include a variety of covenants designed to ensure that the collateral is maintained, insured and available to satisfy the borrower's obligations; and

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[34] The NPR states that "many of the other types of ABS issuances are collateralized by assets that exhibit significant heterogeneity, or assets that by their nature exhibit relatively high credit risk. Such factors make it difficult to develop underwriting standards establishing low credit risk that can be, as a practical matter, applicable to an entire class of underlying assets in the manner described under section 15G."

- the loan documentation must include several specified covenants that require the provision of financial information and restrict the borrower's ability to incur additional debt or transfer or pledge its assets.

A securitization of qualifying commercial loans could not include a reinvestment period, which would be an impractical limitation for most collateralized loan obligations ("CLOs"). A relatively small portion of CLOs are "static" – not providing for a reinvestment period. In addition, commercial loans typically included in CLO pools would not satisfy one or more of the proposed criteria.

Qualifying CRE loans. The proposed rules would define a "CRE loan" to mean a loan secured by a property with five or more single-family units, or by nonfarm non-residential real property, the primary source (50 percent or more) of repayment for which is expected to be derived from the proceeds of the sale or financing of the property, from or rental income derived from non-affiliates of the borrower. A CRE loan would not include a land development and construction loan, a loan on raw or unimproved land, a loan to a real estate investment trust, or an unsecured loan to a developer.

A qualifying CRE loan would be required to meet the following requirements, among others:

- the creditor must verify the borrower's ability to repay its obligations by taking specified steps, including analyzing the borrower's ability to service all outstanding debt obligations during the next two years, and documenting and verifying that the borrower has satisfied all debt obligations over a look-back period of at least two years;

- the DSC ratio must be 1.7 or greater (which may be reduced to 1.5 or greater on certain properties with a demonstrated history of stable net operating income ("NOI")), consistent with a focus on both the sufficiency of the mortgaged property's NOI less replacement reserves to support the payment of principal and interest over the full term of the CRE loan, as well as the financial condition of the borrower (independent of the property's NOI less replacement reserves) to repay other outstanding debt obligations;

- the CRE loan must have a fixed interest rate, though an adjustable rate may be allowed if the borrower obtains a derivative that effectively results in the payment of a fixed rate;

- the loan payments must be based on straight-line amortization not exceeding 20 years from the closing date, with payments required at least monthly over a term of at least 10 years;

- the combined LTV must be 65 percent or less, though in certain cases where very low capitalization rates are used, the maximum ratio is limited to 60 percent;

- the creditor must obtain an appraisal prepared no more than 6 months before the origination date and must conduct an environmental risk assessment of the property;

- the property must be subject to a first lien security interest;

- the documentation must include a variety of covenants designed to ensure that the collateral is maintained and available to satisfy the borrower's obligations, including a covenant to comply with all legal obligations with respect to the property; and

- the documentation must include covenants that require the provision of financial information (including leasing and rent-roll activity) and restrict the borrower's ability to incur additional debt secured by the mortgaged property (even on a subordinated basis) or transfer or pledge the property, other than loans to finance the purchase of machinery and equipment that is pledged as additional collateral for the CRE loan.

Qualifying automobile loans. The proposed rules would define an "automobile loan" as a loan to an individual to finance the purchase of, and secured by a first lien on, a passenger car or other passenger vehicle, such as a minivan, van, sport-utility vehicle, pickup truck, or similar light truck, for personal, family, or household use.[35] An automobile loan would not include any loan to finance fleet sales, a cash loan secured by a previously purchased automobile, a loan to finance the purchase of a commercial vehicle or farm equipment that is not used for personal, family or household purposes, any lease financing, or a loan to finance the purchase of a vehicle with a salvage title. A qualifying auto loan could be for a new or used vehicle.

A qualifying auto loan would be required to have the following characteristics, among others:

- the creditor must verify the borrower's ability to repay its obligations by taking specified steps, including verifying and documenting that the borrower is not currently 30 days or more past due on any debt obligation and has not been 60 days or more past due on any debt obligation within the past 24 months, as well as other credit standards similar to those required for a QRM;

- the borrower's monthly debt-to-income ratio may not exceed 36 percent, as would be required for QRMs;

- in an effort to encourage the use of consistent underwriting standards, the creditor must verify and document the borrower's income and debt obligations using a variety of specified methods, though (similar to QRMs) the creditor may satisfy these requirements regarding the borrower's credit history by obtaining at least two credit reports on the borrower, so long as there is no subsequent credit report obtained before closing that indicates that the borrower did not meet any applicable requirements;

- the loan must have a fixed interest rate;

- loan payments must be based on straight-line amortization not exceeding five years, with monthly payments the first of which must be due within 45 days after the closing date;

- the borrower may not be permitted to defer repayment of principal or interest;

- for a new vehicle, the loan term may not exceed 5 years from the closing date, and for a used vehicle, the sum of the loan term and the difference between the current model year and the vehicle's model year cannot exceed 5 years; and

- the borrower must make a minimum down payment (including any trade-in allowance) that is sufficient to pay all title, tax, and registration fees, all dealer-imposed fees, and 20 percent of the purchase price of the automobile.[36]

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[35] Motorcycles appear not to be included.

[36] Under the proposed rules, the purchase price of a new automobile is the net amount the consumer paid after any manufacturer, dealer, or financing incentive payments or cash rebates are applied. The purchase price of a used automobile is the lesser of the actual purchase price and the value of the automobile (as determined by a nationally recognized automobile pricing agency, such as N.A.D.A. or Kelley Blue Book).

Depositor certification; preservation of exemption. For a securitizer to qualify for zero percent risk retention for qualified commercial loans, CRE loans or automobile loans, the depositor would be required to certify that "it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the asset-backed security" meet the applicable underwriting standards.

If after the closing of a securitization it is discovered that one or more securitized loans does not satisfy all of the applicable criteria, the sponsor would not lose its exemption from the risk retention requirement if:

- the depositor complied with the certification requirement described above;
- within 90 days of discovery of the noncompliance, the sponsor repurchases all affected loans from the trust for a price equal to not less than the unpaid principal balance plus accrued interest; and
- the sponsor promptly notifies securityholders of the noncompliance and the repurchase.

Other Exemptions

Various portions of Section 15G require or permit the Agencies to adopt other exemptions from the risk retention requirements for certain types of ABS transactions. The Agencies have proposed the following exemptions:

- any securitization transaction collateralized solely (other than cash or cash equivalents) by residential, multifamily, or health care facility mortgage loan assets that are insured or guaranteed as to payment of principal and interest by the United States or an agency of the United States;[37]
- any securitization transaction in which the ABS are insured or guaranteed as to payment of principal and interest by the United States or an agency of the United States and collateralized solely (excluding cash and cash equivalents) by residential, multifamily, or health care facility mortgage loan assets, or interests in such assets;[38]
- any securitization transaction in which the ABS are collateralized solely (excluding cash and cash equivalents) by obligations issued by the United States or an agency of the United States, collateralized solely (excluding cash and cash equivalents) by assets that are *fully* insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States, or *fully* guaranteed as to the timely payment of principal and interest by the United States or any agency of the United States;
- any securitization transaction that is collateralized solely (excluding cash and cash equivalents) by loans or other assets made, insured, guaranteed, or purchased by any institution that is supervised by the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation; and
- ABS that are issued or guaranteed by any state of the United States, or by any political subdivision of a state or territory, or by any public instrumentality of a state or territory that is exempt from the

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[37] Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are specifically deemed not to be agencies of the United States.
[38] *E.g.*, Ginnie Mae securitizations.

registration requirements of the Securities Act under Section 3(a)(2), or that are defined as "qualified scholarship funding bonds" in Section 150(d)(2) of the Internal Revenue Code of 1986, as amended.

It does not appear that any proposed exemption would cover student loans originated under the Federal Family Education Loan Program ("FFELP"). Most FFELP loans are guaranteed only as to 97 percent of principal and interest, for loans originated from July 1, 2006 to July 1, 2010, or 98 percent, for loans originated from October 1, 1993 to July 1, 2006, and therefore would not appear to qualify as "fully" guaranteed, absent further guidance from the Agencies.

Resecuritizations

Most resecuritizations would be subject to the risk retention requirements, even if the sponsors of the underlying securities had already complied with the risk retention rules in the securitization of the underlying assets. Repackagings of corporate debt would also be subject to risk retention.

The proposed rules would provide a narrow exemption from the risk retention requirements for resecuritizations under two conditions:

- the transaction must be collateralized solely by existing ABS issued in a securitization for which credit risk was retained as required under the rule or which was exempted from the credit risk retention requirements of the rule ("15G-compliant"); and
- the transaction must involve the issuance of only a single class of ABS interests and provide for the pass-through of all principal and interest payments received on the underlying ABS (net of the issuing entity's expenses).

Sponsors of resecuritizations that are not structured purely as single-class pass-through securities would be required to meet the credit risk retention requirements with respect to those resecuritizations unless another exemption is available, regardless of whether the sponsor of the underlying ABS retained the required credit risk or qualified for an exemption. Therefore, resecuritizations that re-tranche the credit risk or the prepayment risk of the underlying ABS, or that are structured to achieve a sequential paydown of tranches, would not be exempted. Also, private-label ABS issued before the effective date of the final rules typically will not be 15G-compliant, so resecuritizations of these securities would not be eligible for the limited exemption even if they are structured as single-class pass-through securities.

Limitations on Hedging, Financing and Transfer of Retained Interests

In general, sponsors would be prohibited from transferring or hedging an interest that it is required to retain under the proposed rules, or financing the retained interest on other than a full recourse basis. Third parties that retain any required risk as described above would generally be subject to similar requirements.

A sponsor would be permitted to transfer a retained interest to an affiliate whose financial statements are consolidated with those of the sponsor.

Hedging of Retained Interests

Neither a sponsor nor its consolidated affiliate would be permitted to enter into any transaction or agreement if payments on a related financial instrument, derivative or other position are materially related to the credit risk of any ABS interests that the sponsor or affiliate is required to retain, and the position would in any way limit the financial exposure of the sponsor to the credit risk of interests it was required to retain.

Permitted hedging would include:

- hedges related to interest rates, currency exchange rates or home prices, or tied to other sponsors' securities; and
- credit hedges involving instruments tied to an index that includes ABS, provided that:
    - any class of ABS interests in an issuing entity as to which the sponsor was required to retain risk represents no more than 10 percent of the dollar-weighted average of all instruments in the index; and
    - all classes of ABS interests in all issuing entities as to which the sponsor was required to retain risk represent no more than 20 percent of the dollar-weighted average of all instruments in the index.

Issuing entities' hedging activities would be similarly limited.[39] Any credit protection or hedge obtained by an issuing entity could not limit the financial exposure of the sponsor on any interest required to be retained. For example, a credit insurance policy to cover losses on ABS interests or on a pool of securitized assets could not benefit the retained interest. However, it appears that asset-level insurance or guarantees generally would be permitted.[40]

Financing of Retained Interests

Neither a sponsor nor its consolidated affiliate could pledge an interest it is required to retain as collateral for any financing (including a transaction structured as a repurchase agreement)[41] unless the financing is full recourse to the borrower. The Agencies note in the NPR that if a sponsor or consolidated affiliate were to default under such a financing or otherwise permitted a pledged retained interest to be taken by the lender, the borrower would have violated the prohibitions on transfer of retained interests.

Disclosure Requirements

The proposed rules require that a variety of disclosures be provided to prospective investors "a reasonable period of time prior to the sale" of the ABS and, upon request, be provided to the applicable regulators.

For sponsors electing the horizontal, vertical or L-shaped risk retention options, sponsors would be required to provide information regarding the form of risk retention, the amount of the interest retained by the sponsor or any other party, the material assumptions and methodology used in determining the aggregate amount of ABS interests issued, including those relating to estimated cash flows and the discount rate

[39] Issuing entities, however, would not be considered to be consolidated affiliates of the sponsor for purposes of restrictions applicable to such affiliates.
[40] The NPR notes as an example that the proposed rules would not prohibit loan-level mortgage insurance obtained by a borrower in connection with the origination of a mortgage loan.
[41] Although the proposed rules would prohibit sale of an interest required to be retained, the proposed rules contemplate financings in the form of repurchase agreements.

used,[42] and (for the horizontal option and the horizontal component of the L-shaped option) the material terms of the interest retained.

If vertical or horizontal risk is allocated to an originator, the sponsor would be required, in addition to providing the other applicable information described above, to identify the originator and the amount and form of risk it retains.

If the risk retention requirement is satisfied through retention of a representative sample of the designated pool, disclosure would be required regarding the amount of assets in both the designated pool and the representative sample, material characteristics of the designated pool, the policies and procedures used by the sponsor to ensure compliance with the applicable requirements described above, confirmation of receipt of the required agreed-upon procedures report, and the material assumptions and methodology used in determining the aggregate amount of ABS interests issued. Detailed disclosure would be required with respect to the representative sample pool "in the same form, level and manner" as is provided regarding the securitized assets. For each distribution date, sponsors would be required to provide to investors a comparison of the performance of the retained sample with the performance of the pool assets.

For a revolving asset master trust with respect to which the risk retention requirement is satisfied through retention of a seller's interest, the sponsor would be required to disclose the amount of the seller's interest retained by the sponsor and the amount that the sponsor is required to retain under the rule, the material terms of the seller's interest, and the material assumptions and methodology used in determining the aggregate amount of ABS interests issued.

For CMBS with respect to which the risk retention requirement is satisfied through retention of an eligible horizontal residual interest by a third party, the sponsor would be required to identify the B-piece buyer, describe the amount of the interest retained by that party, the price paid, the material terms of the retained interest, and the B-piece buyer's experience in investing in CMBS, and provide any other information about the B-piece buyer "that is material to investors in light of the circumstances of the particular securitization transaction." Disclosure also would be required regarding loan-level representations and warranties, whether any of the securitized loans do not comply with those representations and warranties, and what factors were used in determining that the affected loans should be included in the securitized pool notwithstanding such noncompliance.[43]

For ABCP with respect to which the risk retention requirement is satisfied by an originator-seller's retention of a residual interest, sponsors would be required to disclose to investors the identity of each originator-seller that retains a residual interest and each liquidity provider, and describe the form, amount and nature of each residual interest and the liquidity coverage.

For securities guaranteed by Fannie Mae or Freddie Mac as to which the risk retention requirement is satisfied by that guarantee, the sponsor would be required to describe the manner in which it met its credit risk retention requirement.

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[42] Other assumptions that would likely be material, according to the Agencies, include estimated default rate, prepayment rate, the time between default and recoveries on the underlying assets, and interest rate projections for assets with variable interest rates. In the NPR, the Agencies expressed concern that "[d]epending on the circumstances, a sponsor may have an incentive to inflate the value of the underlying collateral and the ABS supported by such collateral (for example, to increase the proceeds from the securitization transaction) or to underestimate the value of such collateral and ABS (for example, to reduce the sponsor's risk retention requirement)."

[43] What the Agencies intended here is unclear. It is possible that this disclosure item was intended to address loan underwriting criteria rather than representations and warranties.

Safe Harbor for Foreign Transactions

The proposed rules include a safe harbor for certain foreign transactions. Under the safe harbor, the risk retention requirements would not apply to a securitization transaction if:

- the securities are not required to be and are not registered under the Securities Act;
- no more than 10 percent of the dollar value by proceeds (or equivalent if sold in a foreign currency) of all classes of ABS interests are sold to U.S. persons[44] or for the account or benefit of U.S. persons;
- neither the sponsor nor the issuing entity is organized under the laws of the U.S. or a U.S. state or territory, or is an unincorporated branch or office located in the U.S. of an entity not organized under the laws of the U.S. or a U.S. state or territory (a "U.S.-located entity"); and
- no more than 25 percent of the assets were acquired by the sponsor, directly or indirectly, from any consolidated affiliate of the sponsor or issuing entity that is a U.S.-located entity.

The safe harbor would not be available for any transaction or series of transactions that technically complies with the safe harbor but is part of a plan or scheme to evade the risk retention requirements of Section 15G and the proposed rules.

[44] "U.S. person" has substantially the same meaning as under Rule 902(k) of Regulation S.

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