Clients&FriendsMemo

Proposed Credit Risk Retention Requirements for Asset-Backed Securities Transactions

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I. Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Act**") was signed into law by President Obama on July 21, 2010.[1] On March 28, 2011, the Federal banking agencies (the Office of the Comptroller of Currency, the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System), the Securities and Exchange Commission ("**SEC**"), the Department of Housing and Urban Development ("**HUD**"), and the Federal Housing Finance Agency ("**FHFA**") (collectively, the "**Agencies**") released a joint notice of proposed rulemaking (the "**NPR**")[2] containing proposed rules ("**Proposed Rules**") to implement the credit risk retention requirements of Section 941(b) of the Act, codified as Section 15G ("**Section 15G**") of the Securities Exchange Act of 1934 (the "**Exchange Act**").

The Agencies have requested comments to the Proposed Rules by June 10, 2011. The regulations will become effective, with respect to RMBS, one year after publication of the final rules in the Federal Register, and two years after such publication with respect to all other ABS.

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[1] Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act's application to specific industries, entities and transactions. To see these other memoranda, please see *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Appendix A links to the various topic-focused memoranda) or visit our website at http://www.cadwalader.com/list_client_friend.php.

[2] See "Notice of Proposed Rule Making on Credit Risk Retention".

Section 15G generally requires the applicable Agencies to jointly prescribe regulations to (i) require a securitizer to retain at least 5% of the credit risk of any asset it, through the issuance of asset-backed securities, transfers, sells, or conveys to a third party, and (ii) prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain under Section 15G and the rules implemented thereunder.

The Proposed Rules generally require sponsors to satisfy the 5% risk retention requirements for assets they securitize and provides some alternatives for retention by originators and other third parties as discussed below. The retention would be required for the entire life of the transaction, with a prohibition on direct or indirect hedging or transferring the credit risk required to be retained. One of the more unexpected and controversial proposals would require any up-front premium received at closing (which, for example, may result from issuing interest-only securities and other premium bonds) to be deposited into a premium capture cash reserve account for the life of the securitization. This reserve account is in addition to the 5% retention requirement and would absorb losses on the securitized assets — even before any 5% retention interests.

The Proposed Rules would apply to a sponsor of an ABS offering regardless of whether or not such offering is registered with the SEC under the Securities Act of 1933 (the "**Securities Act**").

II. Party to Retain Risk

A. Sponsor

Under the Proposed Rules, the "sponsor"[3] (including CLO managers)[4] of a "securitization transaction"[5] in which "asset-backed securities" ("**ABS**")[6] are issued would generally be required to

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[3] "**Sponsor**" means a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.

[4] 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. CLO managers would thus be required to satisfy the risk retention requirements in connection with each CLO transaction they manage unless (x) the transaction does not permit reinvestment and (y) each commercial loan in the CLO is newly originated and otherwise satisfies specified underwriting standards in order to qualify for an exemption as summarized in Part IV.B of this memorandum. As a practical matter, CLO managers may find it very difficult to structure a CLO transaction that satisfies the commercial loan exemption requirements.

[5] "**Securitization Transaction**" means a transaction involving the offer and sale of asset-backed securities by an issuing entity.

[6] "**Asset-Backed Security**" has the same meaning as in Section 3(a)(77) of the Exchange Act, which (a) means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including: (i) a collateralized mortgage obligation; (ii) a collateralized debt obligation; (iii) a collateralized bond obligation; (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the SEC, by rule, determines to be an asset-backed security for the purposes of the risk retention requirements of the Act; and (b) does not include a security issued by a finance subsidiary

retain an economic interest in the credit risk of the "securitized assets"[7], unless otherwise exempted under the Proposed Rules. If there is more than one sponsor of a securitization transaction, each sponsor is required to ensure that at least one of the sponsors retains an economic interest in the credit risk of the securitized assets.

> *Note: The NPR states that "synthetic" securitizations are not within the scope of the Proposed Rules since the term asset-backed security for purposes of Section 15G includes only those securities that are collateralized by self-liquidating financial assets.*

B. Originator

The Proposed Rules would permit a sponsor to allocate its risk retention obligations to originator(s)[8] of the securitized assets in certain circumstances and subject to certain conditions.

For purposes of the Proposed Rules, an "originator" is the original creditor of a loan or receivable (i.e., the entity that "created" such loan or receivable), and not a subsequent purchaser or transferee.[9] A sponsor that satisfies its base risk retention requirement either under the vertical risk retention option or the horizontal risk retention option would be allowed to allocate a portion of its risk retention obligation to any originator of underlying assets in the securitization transaction that contributes at least 20% of the underlying assets to the pool. The amount of risk retention that the originator may assume must be at least 20% but cannot exceed the percentage of securitized assets it originated. The originator would be subject to all of the same requirements for holding the risk retention amount and would be subject to the same restrictions on transfer, hedging and financing imposed on the sponsor as summarized in sub-section I below.

> *Note: Although the percentage of the risk retention requirement that can be allocated to an originator cannot exceed the percentage of securitized assets originated by such originator, the risk retention by such originator is with*

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held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.

[7] "**Securitized Asset**" means an asset that: (1) is transferred, sold, or conveyed to an issuing entity; and (2) collateralizes the ABS Interests issued by the issuing entity. Under the Proposed Rules, "**ABS Interest**" (1) includes any type of interest or obligation issued by an issuing entity, whether or not in certificate form, including a security, obligation, beneficial interest or residual interest, payments on which are primarily dependent on the cash flows of the collateral owned or held by the issuing entity; and (2) does not include common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests that: (i) are issued primarily to evidence ownership of the issuing entity; and (ii) the payments, if any, on which are not primarily dependent on the cash flows of the collateral held by the issuing entity.

[8] "**Originator**" means a person who: (1) through an extension of credit or otherwise, creates an asset that collateralizes an asset-backed security; and (2) sells the asset directly or indirectly to a securitizer.

[9] The Proposed Rules employ the same definition of "originator" as found in Section 15G. See note 8 above.

respect to the entire pool of securitized assets, not just the assets originated by such originator. The Agencies have requested comment as to whether allocation to originators that originated less than 20% of the securitized assets should be permitted, whether allocation should be permitted in cases where the sponsor elects another form of risk retention and whether an originator should permit or require an originator to retain exposure only to the assets originated by such originator.

C. Other Parties

As discussed below, the sponsor could satisfy its risk retention obligations if risk is retained by B-piece buyers in CMBS transactions or originator-sellers in certain asset-backed commercial paper conduits.

III. Permissible Forms of Risk Retention

The Proposed Rules provide sponsors with multiple risk-retention options, with no specific method being required for any particular type of securitization. The Agencies have requested comments as to whether they should mandate specific manners of risk retention for specific types of securitizations. Although there is no mandated form of risk retention for any type of securitization, it is clear that certain forms will apply, by their terms or through practical constraints, only to certain types of securitizations.

A. Vertical Risk Retention

A sponsor may satisfy its risk retention requirements by retaining at least 5% of each class of ABS Interests issued as part of the securitization transaction. The Proposed Rules are vague on how the size of each tranche should be measured and state that regardless of the method of measurement, the amount retained "should at least equal 5% of the par value (if any), fair value, and number of shares or units of each class." The intent is for the sponsor to be exposed to 5% of the credit risk borne by each class of investor such that the sponsor has exposure to the entire collateral pool and an economic interest in the entire structure of the securitization transaction.

Required Disclosure: The Proposed Rules would require that the sponsor cause to be provided to potential investors a reasonable time prior to the sale of the related ABS and, upon request, to the SEC or appropriate federal banking agency (if any) disclosure regarding the amount of each ABS Interest that the sponsor will or has retained and the amount of each such tranche required to be retained under the rules, in each case expressed both as a percentage and a dollar amount. The Proposed Rules would also require a sponsor to cause to be disclosed the material assumptions and methodologies it used to determine the aggregate dollar amount of ABS Interests issued, including those pertaining to any estimated cash flows and discount rate used.

B. Horizontal Risk Retention

The risk retention requirements can also be satisfied by a sponsor retaining an "eligible horizontal residual interest" in the issuer that is at least equal to 5% of the par value of all ABS Interests issued as part of the securitization transaction. In order to be an eligible horizontal residual interest, such interest must be a "first-loss" position, which cannot be reduced in principal amount (other than through the absorption of losses) more quickly than any senior interests. The Proposed Rules state that a retained interest is an eligible horizontal residual interest only if it is an ABS Interest that is allocated all losses on the securitized assets until the par value of the class is reduced to zero and has the most subordinated claim to payments of both principal and interest by the issuing entity.

> *Note: A residual interest that does not represent funded overcollateralization at closing and is only entitled to excess interest payments would not likely be an "eligible horizontal interest".*

The Proposed Rules would allow the holder of a horizontal residual interest to receive its pro rata share of principal payments[10] but would prohibit such holder from receiving any principal payments from unscheduled distributions on the underlying collateral, whether through sale and disposition or prepayments. This would not accommodate the typical step-down in the principal prepayment shifting-interest structure typically used in prime RMBS securitizations.

Cash Reserve. In lieu of holding an eligible horizontal residual interest in securities, the Proposed Rules would allow a sponsor to fund a cash reserve account to be held with the deal trustee in an amount equal to no less than 5% of the par value of all ABS Interests issued in the securitization transaction. The account would be required to be structured to absorb the same first loss risks as would be absorbed by retained horizontal residual securities. To that end, cash in the reserve account must be used to satisfy the first losses on the underlying collateral in the same way as an eligible horizontal residual interest. Until all ABS Interests are paid in full or the issuer is dissolved, amounts in the account may not be released to the sponsor other than (1) as a result of scheduled principal payments (and in an amount equal to the proportional share of scheduled principal payments that an eligible horizontal residual interest would receive) to the extent paid in accordance with the transaction documents and (2) interest payments received in the account in respect of its permitted investments.

Required Disclosure. The disclosure requirements for horizontal risk retention are similar to those for a vertical interest summarized above, but also would require a description of the material terms

[10] The pro rata share of scheduled principal payments would be pro rata to the percentage that the residual interests represent at the time of prepayment, i.e. taking into account reductions of the prepayment due to absorption of allocated losses.

of the eligible horizontal residual interest, such as when losses are allocated to such interest or when the holder of such interest may receive payments. If the cash reserve account option is selected, the disclosure would need to be modified to reflect the specific attributes of such account.

C. CMBS B-Piece Buyer Retention

For CMBS transactions, the Proposed Rules would allow the risk retention obligations to be satisfied by a third-party purchaser (B-piece buyer) of the junior subordinated interest that agrees to retain the required level of risk exposure as horizontal risk retention. The B-piece buyer would be required to satisfy, and would be subject to, all of the requirements set forth in the Proposed Rules that would otherwise apply to the sponsor, including the prohibitions on hedging and transferring any portion of the risk required to be so retained. The Proposed Rules require that any such person be a third-party purchaser that specifically negotiates for the purchase of the first-loss position and conducts its own credit analysis of each commercial loan backing the CMBS.

Satisfaction of the risk retention requirements by means of the B-piece buyer alternative would only be available for securitization transactions where commercial real estate loans constitute at least 95% of the unpaid principal balance of assets being securitized. The Proposed Rules define "commercial real estate loans" as loans that are secured by multi-family or nonfarm nonresidential real property if 50% or more of the source of repayment is expected to be derived from proceeds of sale or refinancing of the property or rental income from the property (other than from tenants affiliated with the borrower). Excluded from the definition of "commercial real estate loans" are (i) land loans;[11] (ii) loans to REITs; and (iii) unsecured loans to developers.

> *Note: The exclusion of loans expected to be repaid more than 50% from rental income received from tenants affiliated with the borrower would appear to make transactions where SPE borrowers lease their properties to affiliated operating companies (e.g., PropCo./OpCo. structures) ineligible to satisfy risk retention through the B-piece buyer retention alternative.*
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> *It is unclear why loans to REITs are excluded from the definition of commercial real estate loans. There is no commentary on this point. Since REITs are significant participants in the commercial real estate development industry, this restriction would appear to eliminate a high proportion of commercial mortgage loans from eligibility for transactions that seek to satisfy risk retention through the B-piece buyer structure.*[12]

[11] It is unclear whether "land loans" would include loans made to borrowers that ground lease their fee interests and the related ground rent payments serve as the only source of payments on the loan.

[12] It is unclear whether a special purpose vehicle owned by a REIT would be captured by this exclusion.

Satisfaction of the risk retention requirement for CMBS transactions by use of the B-piece buyer retention alternative is subject to satisfaction of the following six conditions:

- The B-piece buyer must retain an eligible horizontal residual interest (i.e., the junior-most interest) in the securitization 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 first-loss subordinated interest in cash at closing without financing from any other party to the securitization (other than a person that is a party solely by virtue of being an investor).

- The B-piece buyer must conduct an independent review of the credit risk of each asset in the pool prior to the sale of the ABS, which must include, at a minimum, a review of the underwriting standards, collateral and expected cash flows of each loan in the pool.

- The B-piece buyer may not have any control rights in the securitization (including, but not limited to, acting as servicer or special servicer) that are not collectively shared by all other investors in the securitization unless an independent operating advisor with prescribed powers and responsibilities is appointed.

  Note: The NPR states that investors and regulators are concerned about potential conflicts of interest between B-piece buyers (due to their control rights and servicing role) and other investors. The Proposed Rules strengthen the rights and responsibilities of the operating advisor as compared with recent CMBS 2.0 transactions in several ways. For instance, the operating advisor must have the authority to recommend the replacement of a special servicer that is affiliated with the B-piece buyer if it determines that the special servicer has failed to comply with the servicing standard and such special servicer must then be replaced unless a majority of each class of CMBS from the transaction votes to retain the special servicer.

  Although not completely clear, the fourth condition appears to restrict the third party purchaser from having any affiliation with other deal parties and from having any control rights (i.e., the existence of either an affiliation or control rights would be inconsistent with reliance on the B-piece buyer structure for risk retention). The existence of an operating advisor having the rights described in the Proposed Rules would permit the B-piece buyer both to act as (or be affiliated with) the special servicer and/or to have control rights related to servicing. However, since the prescribed roles of the operating advisor relate exclusively to oversight of an affiliated servicer, it is unclear how having an operating advisor would address the Agencies' perceived concerns with the B-piece buyer having control rights, where the B-piece buyer has no affiliation with the special servicer.

- The sponsor must provide disclosure of the name, form of organization and experience of the B-piece buyer and any other information material to investors in light of the circumstances of the transaction. Additionally, the sponsor would be required to disclose the amount of the eligible horizontal residual interest that the B-piece buyer has or will retain, the purchase price, material terms of the interest and the amount that the sponsor would have been required to retain if the sponsor had retained such interest, as well as certain other asset-specific disclosures.

  Note: The requirement to disclose the purchase price at which a B-piece buyer acquires its position seems to be particularly troublesome, because most issuers, underwriters and investors would consider that information to be proprietary and confidential.

- The B-piece buyer must comply with the hedging, transfer and other restrictions applicable to such interest under the Proposed Rules.[13]

  Note: It would be necessary for B-piece buyers to agree to hold their investments for the life of the CMBS transaction, which may be a difficult commitment for certain entities to make. In addition, the restrictions on hedging and non-recourse financing of the retained B-pieces would impose new restrictions on the businesses of B-piece buyers. These restrictions would not permit B-piece buyers to use CRE CDOs to finance the B-pieces they are required to retain, as was common prior to the credit crisis.

Although the sponsor can satisfy its retention obligations through the B-piece buyer retention alternative, the sponsor would remain responsible for compliance by the B-piece buyer of the retention obligations. As such, the Proposed Rules would require the sponsor to maintain and adhere to policies and procedures to monitor the B-piece buyer's compliance. If the sponsor determines that the B-piece buyer no longer complies with the retention requirement it must notify investors in the related ABS.

D. L-Shaped Risk Retention

The Proposed Rules would also allow a combination of horizontal and vertical risk retention as a means of satisfying the risk retention requirements. Under this option, the sponsor must retain (i) a vertical component of not less than 2.5% of each class of ABS Interests issued as part of the securitization and (ii) a horizontal component of not less than 2.564% of the par value of all ABS Interests in the issuing entity, other than those interests required to be retained as part of the vertical component (i.e., 2.5% of all ABS issued, including the portion retained as vertical risk

[13] For more detail on these restrictions and the narrow exceptions thereto, see Part III.I below: Hedging, Transfer and Financing Restrictions.

retention). The combined amount of the vertical component and horizontal component would be 5% of the aggregate transaction. The Proposed Rules require 50% of the required risk retention in each of the horizontal and vertical components.

> *Note: The Proposed Rules require that at least 2.5% of vertical and horizontal risk be retained, and do not permit a lesser retention in either form to be offset by a greater retention in the other form. The NPR indicates this proposal is designed to ensure that retention in either form be large enough to represent a meaningful retention of the risks represented by that form and also suggests that retention of at least 2.5% will be easier for investors and regulators to monitor.*
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> *As pointed out in the discussion of the CMBS B-piece buyer retention option above, since the B-piece buyer retention alternative seems to be a form of eligible horizontal retention, it appears that if the B-piece is less than 5%, the sponsors could "top up" the retention to 5% by retaining a 2.5% vertical strip of all ABS interests. It is less clear that in such transactions the sponsors can "top up" by retaining additional risk in the form of an additional eligible horizontal retention (although such a result would be logical).*

Required Disclosure: As this option includes a horizontal and a vertical component, the disclosure requirements of each of those components as discussed above would apply.

E. Revolving Asset Master Trusts (Seller's Interest)

Revolving asset master trusts are often used for securitizations when the underlying assets consist of revolving lines of credit (e.g., credit card accounts). These trusts issue multiple series of ABS Interests that are backed by a single pool of revolving lines of credit that are expected to change in composition over time. The sponsors of these trusts typically hold a direct interest in the revolving lines of credit backing the ABS Interests. Prior to the occurrence of an early amortization event, the sponsor's interest is *pari passu* with the interests of the holders of the ABS Interests in the revolving lines of credit backing the ABS Interests.

The Proposed Rules would allow a sponsor of a revolving asset master trust that is backed by revolving lines of credit to satisfy the risk retention requirement by maintaining a "seller's interest" in an amount not less than 5% of the unpaid principal balance of all of the assets held by the revolving asset master trust.[14]

The Proposed Rules define a "revolving asset master trust" as an issuing entity that is (i) a master trust; and (ii) established to issue more than one series of ABS, all of which are collateralized by a

[14] A sponsor of a revolving asset master trust may elect to use another option to satisfy the risk retention requirement.

single pool of revolving securitized assets that are expected to change in composition over time. This definition is intended to be consistent with market practices.

The Proposed Rules define a "seller's interest" as an ABS Interest (i) in all of the assets that are held by the issuing entity and that do not collateralize any other ABS Interests issued by the entity; (ii) that is *pari passu* with all other ABS Interests issued by the issuing entity with respect to the allocation of all payments and losses prior to an early amortization event (as defined in the transaction documents); and (iii) that adjusts for fluctuations in the outstanding principal balances of the securitized assets.

> *Note: Both the definition of "revolving asset master trust" and "seller's interest" are intended to be consistent with market practices. The definition of "seller's interest" is also designed to make sure that the interest retained by the sponsor would expose the sponsor to the credit risk of the assets backing the related ABS Interests.*

Required Disclosure. If a sponsor of a revolving asset master trust elects to use the seller's interest option to satisfy the risk retention requirement, the Proposed Rules would require that the sponsor disclose or cause to be disclosed in writing to potential investors (i) the amount of the seller's interest that the sponsor will or has retained in the transaction at closing and the amount that the sponsor is required to retain under the rules, in each case, expressed both as a percentage and a dollar amount, and (ii) a description of the material terms of such interest. The Proposed Rules would also require the sponsor to provide or cause to be provided in writing to potential investors the material assumptions and methodologies (including any estimated cash flows and the discount rate) it used to determine the aggregate dollar amount of ABS Interests issued by the revolving asset master trust in the securitization transaction.[15] All of the foregoing information must be provided within a reasonable period of time prior to the sale of the ABS Interests.

F. Representative Sample

The Proposed Rules allow sponsors to meet the risk retention requirements by retaining a randomly selected representative sample of assets that is equivalent, in all material respects, to the assets that are transferred to the issuing entity and securitized, subject to certain conditions. The unpaid principal balance of all the assets in the representative sample would be required to equal at least 5% of the aggregate unpaid principal balance of all the assets in the "designated pool" from which the securitized assets and the representative sample are drawn. The Proposed Rules would mandate a specific process for selecting the representative sample. The sponsor must identify a designated pool of no less than 1,000 separate assets, which cannot contain any assets other than

[15] Upon request, all of the forgoing information must also be provided to the SEC and any appropriate federal banking agency.

those that are to be either securitized or selected for the representative sample. Then the sponsor must use a random selection process to select loans for the representative sample based on no characteristic other than unpaid principal balance. Finally, the sponsor must evaluate the representative sample to ensure that for each material characteristic of the assets the sample of assets randomly selected is within a 95% two-tailed confidence interval of the mean or proportion, as applicable, of the same characteristic of all the assets in the designated pool. The Agencies did not specify which characteristics would be considered material, although the illustrative examples used in the NPR indicate that they believe interest rates, debt-to-income ratios and geographic concentration may be material.

> *Note: The 1,000 asset minimum size for the designated pool would render representative sample a practical impossibility for asset classes, such as CMBS, that involve the securitization of small numbers of high-balance loans and would render its use difficult for other asset classes as well. For instance, an RMBS sponsor may have great difficulty in any period compiling a pool of at least 1,000 assets having the necessary homogeneity required for a particular securitization (such as all fixed or adjustable interest rates or comparable original terms to maturity), rendering reliance on this method an impairment to efficiently and quickly securitizing an originator's pipeline of newly originated loans. One adverse affect of any delay imposed in order to accumulate the loans required to meet the minimum designated pool size might be the inability of originators to offer borrowers interest rate locks. We question why the Agencies chose 1,000, rather than 100 assets, the minimum pool size used in the comparable European credit risk retention regulations.*
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> *If the servicer does not know which assets are securitized and which are not, information about all loans in the securitization and the representative sample will need to be reported to another securitization party, who will have to separate information about the securitized assets from the non-securitized assets, which may entail additional cost. This effect would be avoided if the Agencies were to clarify that appropriate personnel of the servicer could review and separate information about the representative sample and the securitized pool provided by the "hands-on" servicing personnel prior to reporting the information to other securitization parties.*

Sponsors using the representative sample to satisfy the risk retention requirements would be required to adhere to specific policies and procedures for identifying and documenting the material characteristics of the assets in the designated pool, randomly selecting assets for the representative sample, testing the assets in the representative sample and ensuring that those assets remain segregated from the designated pool for any other securitization. Prior to sale of the ABS Interests in the related securitization, the sponsor would be required to obtain an agreed upon procedures report from an independent, public accounting firm, reporting on whether the sponsor

has the required policies and procedures in place. Once an acceptable agreed upon procedures report has been obtained it may be used for subsequent securitizations.[16]

In order to ensure like treatment of the representative sample and the securitized assets, the servicing of the representative sample is required to be performed by the same entity and under the same contractual standards as the servicing of the assets in the securitization pool. The individuals responsible for servicing the representative sample must not be able to determine whether an asset is part of in the representative sample or the securitization pool.

Sponsors would be required to comply with the hedging, transfer and sale restrictions summarized in sub-section H below with respect to assets in the representative sample. Sponsors would also be prohibited from removing assets from the representative sample or permitting the assets therein to be used in any other designated pool or representative sample in connection with any other securitization transaction until all ABS Interests are repaid.

Required Disclosures. The following disclosures would be required to be made, prior to securitization, to potential investors and, upon request, to the SEC and to the sponsor's Federal banking regulator:

- The amount (expressed as a percentage of the designated pool and dollar amount) of assets included in the representative sample to be retained by the sponsor.
- The amount (expressed as a percentage of the designated pool and dollar amount) of assets required to be included in the representative sample and retained by the sponsor.
- A description of the material characteristics of the designated pool and the representative sample, including, but not limited to, the average unpaid principal balance of the assets in the designated pool and the representative sample, the means of the quantitative characteristics and proportions of characteristics that are categorical in nature with respect to each of the material characteristics of the assets in the designated pool and the representative sample, of appropriate introductory and explanatory information to introduce the characteristics, the methodology used in determining or calculating the characteristics, and any terms or abbreviations used.
- A description of the policies and procedures that the sponsor used for ensuring that the process for identifying the representative sample complies with the proposal and that the

[16] In the NPR, the Agencies note that if the sponsor's policies and procedures change in any material respect, a new agreed upon procedures report would be required.

representative sample has equivalent material characteristics to those of the pool of securitized assets.

- Confirmation that an agreed upon procedures report was obtained as required by the proposal.

- The material assumptions and methodology used in determining the aggregate dollar amount of ABS Interests issued by the issuing entity, including those pertaining to any estimated cash flows and the discount rate used.

Further, after the sale of the ABS, the sponsor would be required to provide, or cause to be provided, to investors at the end of each distribution period a comparison of the performance of the pool of securitized assets for the related distribution period with the performance of the assets in the representative sample for the related distribution period. A sponsor selecting the representative sample option also would be required to provide investors disclosure concerning the assets in the representative sample in the same form, level, and manner as it provides, pursuant to rule or otherwise, concerning the securitized assets. Therefore, if loan-level disclosure concerning the securitized assets was required, by rule or otherwise, to be provided to investors, the same level of disclosure would also be required concerning the representative sample.

G. Asset-Backed Commercial Paper Conduits

A sponsor of an eligible asset-backed commercial paper ("**ABCP**") conduit ("**eligible ABCP conduit**") may satisfy the risk retention requirements if each originator-seller that transfers assets to collateralize the ABCP issued by the conduit retains an eligible horizontal residual interest in each intermediate SPV established by or on behalf of that originator-seller for purposes of issuing interests to the eligible ABCP conduit. The eligible horizontal residual interest retained by the originator-seller must equal at least 5% of the par value of all interests issued by the intermediate SPV. Each originator-seller would be required to retain credit exposure to the receivables sold by that originator-seller to support issuance of the ABCP.

> *Note: This risk retention option is narrow in scope and would not be available to many ABCP programs, including structured investment vehicles, securities arbitrage programs and other arbitrage programs and other programs that don't satisfy the "eligible ABCP conduit" criteria.*

The Proposed Rules define "eligible ABCP conduit" as an issuing entity that issues ABCP meeting each of the following criteria:

- The issuing entity must be bankruptcy remote or otherwise isolated for insolvency purposes from the sponsor and any intermediate SPV.

- The ABS issued by an intermediate SPV to the issuing entity must be collateralized solely by assets originated by a single originator-seller.

  Note: Not all conduits utilize the intermediate SPV structure and, if such structure is used, it is not clear why there is a requirement of only one originator-seller for each intermediate SPV so long as each originator-seller retains 5% of the risk.

- All the interests issued by an intermediate SPV must be transferred to one or more ABCP conduits or retained by the originator-seller.

  Note: Again, not all conduits utilize the intermediate SPV structure and, if such structure is utilized, it is not clear why all interests must be transferred to one or more ABCP conduits (other funding sources may be available).

- A regulated liquidity provider[17] must have entered into a legally-binding commitment (in certain specified forms) to provide 100% liquidity coverage to all the ABCP issued by the issuing entity by lending to, or purchasing from, the issuing entity in the event that funds are required to repay maturing ABCP issued by the issuing entity.

  Note: Not all conduits have 100% liquidity coverage and, if they do, it is not clear why a "regulated" (as defined in the Proposed Rules) liquidity provider is required so long as such provider has the requisite rating (i.e., the same rating as the ABCP). Why not allow insurance companies and other highly rated companies to be liquidity providers?

  If the conduit does not satisfy the "eligible ABCP conduit" criteria, the sponsor must retain credit risk in accordance with another risk retention option included in the Proposed Rules (unless an exemption for the transaction exists).

The Proposed Rules would require the sponsor of an eligible ABCP conduit that issues ABCP in reliance on this risk retention option to be responsible for compliance with the requirements of this option. The sponsor must maintain policies and procedures to monitor the originator-sellers' compliance with the requirements of the proposal and must promptly notify investors of any non-compliance. The sponsor would be required to (i) establish and maintain the eligible ABCP conduit

[17] "Regulated liquidity provider" means: (1) a depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)); (2) a bank holding company (as defined in 12 U.S.C. 1841), or a subsidiary thereof; (3) a savings and loan holding company (as defined in 12 U.S.C. 1467a), provided all or substantially all of the holding company's activities are permissible for a financial holding company under 12 U.S.C. 1843(k), or a subsidiary thereof; or (4) a foreign bank whose home country supervisor (as defined in § 211.21 of the Federal Reserve Board's Regulation K (12 CFR 211.21)) has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision, as amended, and that is subject to such standards, or a subsidiary thereof.

and establish criteria governing assets permitted to be transferred thereto, (ii) approve (1) all originator-sellers and (2) all interests in the intermediate SPVs to be purchased thereby, and (iii) administer the ABCP conduit and maintain and adhere to the policies and procedures for ensuring all requirements have been met.

> *Note: Sponsors may have difficulty monitoring the originator-seller's compliance with the requirements of this option.*
>
> *The terms and conditions of this risk retention option are designed to ensure that the assets of "eligible ABCP conduits" have low credit risk and that originator-sellers have incentives to monitor the quality of such assets.*

Required Disclosure. Sponsors must disclose the name and form of organization of each originator-seller that will retain (or has retained) an interest in the securitization transaction and of each regulated liquidity provider that provides liquidity support to the eligible ABCP conduit (including a description of the form, amount and nature of such liquidity coverage).

H. Premium Capture Cash Reserve Account

The most unexpected and controversial aspect of the Proposed Rules is the requirement for a "premium capture cash reserve account." The Proposed Rules would require any monetized excess spread or other premium received at closing to be held in a reserve account as the first-loss position, in addition and subordinate to any 5% retained interest required by the rules as summarized above. The amount of premium that must be captured is defined quite broadly as the amount by which gross proceeds of an ABS offering (net of closing expenses) exceeds 95% of the par amount (if the sponsor retained credit under the vertical, horizontal, L-shaped or revolving asset master trust options) or 100% of the par amount (if retention is accomplished through the representative sample, ABCP conduit or CMBS B-piece buyer alternatives), of the ABS Interests issued.

All amounts in the premium capture cash reserve account would be required to be used to offset losses on the underlying assets before such losses are allocated to any other interest or account. The premium capture cash reserve account rules would apply to all transactions except those otherwise exempt from risk retention (as described below in this memo).

In the NPR, the Agencies expressed the view that the premium capture requirements are so onerous that they expect few, if any, securitizations would be structured to monetize excess spread at closing. It is clear the proposal on the premium capture cash reserve account is intended to eliminate any incentive or benefit to a sponsor of monetizing excess spread up-front at closing.

The commentary in the NPR seems to indicate the Agencies were seeking to head off the use of monetized excess spread to negate the effects of the new risk retention rules. However, while the commentary refers to interest-only securities, these securities have been used in securitization markets for many years, and certainly were not devised to negate the effects of the new risk retention requirements. While the NPR suggests the ability to monetize excess spread "created incentives to maximize securitization scale and complexity, and encouraged aggressive underwriting", it does not explain how the Agencies reached those conclusions and does not otherwise provide any support for those conclusions.

> *Note: One of the benefits of time-tranched ABS structures is to create value by structuring classes of securities with shorter maturity than the terms of the underlying securitized assets, thus permitting those shorter tranches to be priced relative to shorter maturity Treasury bonds, which creates excess spread. The excess spread represents the efficiency achieved through the securitization process, which in turn permits lenders that engage in securitization to provide borrowers with more attractive financing terms relative to "balance sheet" lenders. Effectively removing this efficiency from the securitization market may remove one of the primary benefits of securitization and is likely to result in fewer lenders participating in securitization. This result would seem to be antithetical with the stated goal of the Agencies to provide for stabilized and efficient growth of credit markets. It is unclear whether the Agencies took into account the consequences of this aspect of the Proposed Rules.*
>
> *The premium capture reserve account requirement would create, for no apparent reason, a powerful disincentive to securitize seasoned assets, whose coupons are often likely to be higher than the interest rates on the related ABS Interests, due simply to general movements in the level of market interest rates over time. In the RMBS space, it would also discourage the securitization of loans to borrowers with imperfect credit histories, as these loans generally carry higher interest rates, thereby impairing the flow of credit to the neediest homeowners.*
>
> *The premium capture cash reserve account combines elements of required risk retention and deferral of compensation for sponsors engaged in securitization. While risk retention is expressly addressed by the Act (although only up to a requirement of 5%), deferral of compensation is not expressly authorized by the Act.*

Although the formula for determining the amount of excess spread or premium is based on the gross proceeds, net of closing costs, received by the issuing entity from the sale of ABS Interests, the Proposed Rules contain an anti-evasion provision that is designed to prevent an issuer from retaining, on a short terms basis, an ABS Interest that represents such excess spread or premium and monetizing it at a later date. Specifically, the anti-evasion provision provides that the term

"gross proceeds" will include the par value or fair value, as applicable, of any ABS Interest issued directly or indirectly to a sponsor if (1) the sponsor does not intend to hold such interest until maturity or (2) such ABS Interest represents a contractual right to receive interest and not more than a minimal amount of principal and such ABS Interest has a priority of payment that is senior to the most subordinated class of issued ABS Interests.

I. Hedging, Transfer and Financing Restrictions

The Proposed Rules would prohibit a sponsor from transferring any interest or assets that it is required to retain thereunder to any person other than a consolidated affiliate. Even absent a transfer from the sponsor, the Agencies state that if a consolidated affiliate were permitted to hedge the risks required to be retained under the Proposed Rules, the net effect of the hedge on the organization controlling the sponsor would offset the credit risk retention required and defeat the purpose of Section 15G. Accordingly, consolidated affiliates also would be prohibited from hedging the credit risk the sponsor is required to retain under the Proposed Rules.

Issuing entities, however, would be excluded from the definition of "consolidated affiliate" even if their financial statements are consolidated with those of the sponsor under applicable accounting standards. This is to allow issuing entities to engage in hedging transactions that are for the ultimate benefit of investors in the ABS. The Agencies restrict this allowance, however, by carving out from such permission any credit protection or hedge of the exposure on the particular interests or assets that the sponsor is required to retain under the Proposed Rules. For example, in the vertical risk retention option, an issuing entity may purchase credit protection covering up to 95% of the tranches, but not the 5% required to be retained by the sponsor.

> *Note: The Proposed Rules do not specify how this carveout would apply in cases where the sponsor elects a more complex form of risk retention, presenting a challenge for issuers in hedging any credit exposure or asset-specific risks on a pool-wide basis in such cases.*

Under the Proposed Rules, sponsors and their consolidated affiliates would be prohibited from purchasing or selling a security or other financial instrument or entering into an agreement (including an insurance contract), derivative or other position with any other person if:

- payments on the security or other financial instrument or under the agreement, derivative or position are materially related to the credit risk of one or more particular ABS Interests, assets or securitized assets that the retaining sponsor is required to retain, or one or more of the particular securitized assets that collateralize the ABS; and
- the security, instrument, agreement, derivative or position in any way reduces or limits the financial exposure of the sponsor to the credit risk of one or more of the particular ABS

Interests, assets or securitized assets, or one or more of the particular securitized assets that collateralize the ABS.

The Agencies' stated intention is to focus the hedging prohibition on the credit risk associated with the interest or assets that the sponsor is required to retain, which credit risk is based on the underlying credit risk of the securitized assets backing the ABS Interests issued. Therefore, hedge positions that are not materially related to the credit risk of ABS Interests or exposures required to be retained by the sponsor (or any of its consolidated affiliates) are not prohibited by the Proposed Rules. Examples offered by the Agencies that would not violate the Proposed Rules are (i) hedges related to overall market movements, such as movements of market interest rates (but not the specific interest rates known as spread risk associated with the ABS Interest that is otherwise considered part of the credit risk), (ii) currency exchange rates, (iii) home prices, or (iv) the overall value of a particular broad category of ABS. Hedges tied to securities that are backed by similar assets originated and secured by other sponsors also would not be prohibited. On the other hand, any security, instrument, derivative or contract that referenced the particular interests or assets or requires payment in circumstances where there is or could reasonably be expected to be a loss due to the credit risk of such interests or assets (i.e., credit default swaps referencing such interests or assets) would be prohibited.

The Proposed Rules allow certain hedges based on indices that may include one or more tranches from a sponsor's ABS transactions, such as ABX Index hedges, so long as:

- any class of ABS Interests in the issuing entity that was issued in connection with the securitization transaction and that is included in the index represented no more than 10% of the dollar-weighted average of all instruments included in the index, and
- all classes of ABS Interests in all issuing entities that were issued in connection with any securitization transaction in which the sponsor was required to retain an interest pursuant to the Proposed Rules and that are included in the index represent, in the aggregate, no more than 20% of the dollar-weighted average of all instruments included in the index.

According to the Agencies, these limitations are designed to prevent a sponsor from evading the hedging restrictions through the purchase of indexed hedges based to a significant degree on ABS from securitization transactions in which a sponsor is required to retain risk under the Proposed Rules.

The Proposed Rules would also prohibit a sponsor and its consolidated affiliates from pledging as collateral for any obligation (including a loan, repurchase agreement or other financing transaction)

any interest or asset that the sponsor is required to retain unless the obligation is with full recourse to the sponsor or its consolidated affiliates.[18]

Note: The restrictions on hedging and transfers will likely have a chilling effect on CMBS B-piece buyers that would otherwise be willing to assume the 5% horizontal risk retention requirement.

J. Treatment of Government-Sponsored Enterprises

Guarantees provided by Fannie Mae or Freddie Mac (each, a "**GSE**") while operating under the conservatorship or receivership of the FHFA with capital support from the United States will satisfy the risk retention requirements of such GSE with respect to ABS issues. The NPR notes that because the GSEs fully guarantee the timely payment of principal and interest on their ABS, GSEs are already exposed to the entire credit risk of the mortgages backing those ABS. An equivalent guaranty provided by a limited-life regulated entity that has succeeded to the charter of a GSE and that is operating under the direction and control of the FHFA with capital support from the United States will also satisfy the risk retention requirements. If either GSE or limited-life regulated entity were to begin to operate other than under the conservatorship or receivership of the FHFA, such GSE or entity would no longer be able to avail itself of this option.

Note: Shortly after the Proposed Rules were released, Representative Scott Garrett (R-NJ) introduced a bill entitled, "GSE Credit Risk Equitable Treatment Act of 2011."[19] *This bill is intended to ensure that mortgages held or securitized by, and ABS issued by, GSEs are treated the same as other mortgages and ABS held or securitized by non-GSEs.*

Required Disclosure. A GSE satisfying its risk retention obligations under this alternative would be required to disclose to investors and, upon request, to the FHFA, a description of the manner in which it has met its credit risk retention requirement.

[18] Although the Proposed Rules do not expressly address the disposition of a pledged retained interest, in the NPR the Agencies commented that, where a pledge of an interest or asset to support full recourse financing subsequently results in such interest or asset being taken by the counterparty to the financing transaction (whether by consent, pursuant to exercise of remedies or otherwise), the sponsor will be viewed as having violated the prohibition on transfer. This seems like a strange result as it renders the pledge of the retained interest essentially valueless to the creditor.

[19] See http://financialservices.house.gov/media/pdf/garrett_033.pdf.

IV. Asset Category Exemptions from the Risk Retention Requirements

A. Qualified Residential Mortgages

The risk retention requirements described above would not apply to an issuance of RMBS if all of the assets backing the transaction are qualified residential mortgages ("**QRMs**"). The Proposed Rules define QRMs by setting forth certain minimum underwriting standards that must be present for the loan to qualify as a QRM, as well as prohibiting certain product features. The underwriting and product features proposed for QRMs include standards related to the borrower's ability and willingness to repay the mortgage, the borrower's credit history, the borrower's down payment amount and sources, the loan-to-value ratio, the form of valuation use in underwriting the loan, the type of mortgage involved and the owner-occupancy status of the property. In addition to complying with the underwriting standards, the Proposed Rules also set forth certain certification requirements that need to be met before the sponsor can avail itself of the exemption from risk retention.

The purpose of these standards and procedures is to create a pool of residential mortgages that are of a high enough credit quality to offset the risks that the risk retention rules are otherwise meant to guard against. The definition of QRM was purposefully designed to be narrow and in a manner that would permit sponsors to determine at or prior to the time of origination of the mortgage loans whether such mortgage loans would fit within the definition of QRM. The proposed QRM definition incorporates and uses certain definitions and key terms established by HUD and required to be used by lenders originating residential mortgage loans insured by the FHA, which terms relate to determining and verifying borrower funds and the borrower's monthly housing debt, total monthly debt and monthly gross income.[20] Therefore, due to the very specific nature of these calculations and requirements, a sponsor will need to familiarize itself with all the details of the rules in order to ensure that loans qualify as QRMs. Below is a high-level summary of the criteria necessary for sponsors to benefit from the QRM exemption in RMBS transactions.

> *Note: Under Section 15G, the definition of QRM that the Agencies adopt may not be broader than the definition of "qualified mortgage" ("**QM**") that is ultimately adopted under the Truth in Landing Act ("**TILA**"). Since the definition of QM under TILA has not yet been adopted, the Agencies expect to review the QM rules subsequently adopted under TILA and apply those standards strictly in setting the QRM requirements.*

[20] See Additional QRM Standards Appendix attached to the NPR.

QRM Eligibility Criteria. In order for a mortgage loan to be considered a QRM, it must meet the following requirements at the time of origination:

- *First Lien*. Each mortgage must be a first-lien mortgage to purchase or refinance a one-to-four family property, at least one unit of which must be the principal dwelling of the borrower. A one-to-four family property may include individual condominium or cooperatives units as well as certain manufactured homes.

- *Excluded Mortgage Loans*. Excluded from the QRM definition are construction loans, bridge loans with terms of twelve months or less, loans to purchase time shares and reverse mortgages.

- *No Piggyback Mortgages*. For purchase money mortgages, no other recorded or perfected liens can, to the creditor's knowledge, exist at the time of closing the transaction. Junior liens can exist in connection with refinancings of existing loans provided that the LTV and debt-to-income ratios do not exceed certain thresholds.

- *Maturity Date*. The maturity date of the QRM may not exceed 30 years.

- *Written Application*. The borrower must complete and submit a written application for the mortgage and acknowledge in the application that (i) the information is true and correct and (ii) any intentional or negligent misrepresentation may give rise to civil or criminal liability.

- *Credit History*. Instead of relying on credit scores to establish credit history (which, as the Agencies noted are standards that would require reliance on credit scoring models developed and maintained by privately owned entities that may change from time to time at the discretion of such entities), the Proposed Rules establish certain factors that need to be met to qualify the borrower. These factors are the borrower may not (i) be currently 30 days or more past due on any debt obligation, (ii) be 60 or more days past due, in whole or in part, on any debt obligation within the preceding 24 months and (iii) have been a debtor in a bankruptcy proceeding, had property repossessed or foreclosed upon, engaged in a short sale or deed-in-lieu of foreclosure or subject to a federal or state judgment for collection of any unpaid debt within the preceding 36 months. The originator must also verify and document (within 90 days prior to closing of the mortgage) that the borrower satisfied these requirements. The Proposed Rules would permit the originator to take advantage of a safe harbor in order to satisfy these verification and documentation requirements by obtaining, no more than 90 days before the closing, credit reports from two consumer reporting agencies. This safe harbor would not apply if the creditor later obtained a report prior to closing that indicated that the borrower did not meet these minimum requirements.

- *Payment Terms*. A QRM may not permit for interest-only payments, negative amortization, balloon payments (i.e., no scheduled payment of principal and interest can be more than twice as large as any earlier payment) or prepayment penalties. The Proposed Rules also limit the amount by which the interest rates on an adjustable-rate mortgage loan may increase to 2% in any twelve month period and 6% over the life of the mortgage transaction.

- *Points and Fees*. The points and fees payable by the borrower may not exceed 3% of the total loan amount.

- *Ability to Repay*. As noted in the *NPR*, the ability of a borrower to repay is often measured by looking at the borrower's "front-end ratio", which measures the borrower's mortgage payment to the borrower's gross income, and the borrower's "back-end-ratio", which measures all of the borrower's debt payments to the borrower's gross income. The Proposed Rules require a front-end ratio limit of 28% and a back-end ratio of 36%. Both ratios are required to be calculated in accordance with the particular standards set forth in the Proposed Rules.

- *Loan-to-Value Ratio*. A QRM must have (i) an LTV ratio of 80% for purchase mortgage transactions, (ii) a combined LTV ratio of 75% for rate and term refinances and (iii) a combined LTV ratio of 70% for cash-out refinance loans.

- *Down Payment*. For one-to-four family properties, the Proposed Rules require the borrower provide a cash down payment in an amount equal to at least the sum of (i) the closing costs, (ii) 20% of the lesser of (a) the estimated market value of the property as determined by a qualifying appraisal (as described below) and (b) the purchase price of the property; and (iii) if the estimated market value determined by the qualifying appraisal is less than the purchase price of the property, the difference between these amounts. In order to meet the required down payment, the Proposed Rules specify that the funds must come from certain acceptable sources, such as savings and checking accounts, stocks and bonds and gifts. The down payment may not come from funds that are subject to a contractual obligation by the borrower to repay and funds from a person with an interest in the sale of the property (other than the borrower). Originators will be required to verify and document compliance with these down payment provisions.

- *Qualifying Appraisal*. A QRM must be supported by a written appraisal that conforms to (i) the generally accepted appraisal standards, as evidenced by the Uniform Standards of Professional Appraisal Practice, (ii) the appraisal requirements of the Federal banking agencies and (iii) applicable laws.

- *Assumability Prohibition*. A QRM may not be assumable by any person who was not a borrower under the original mortgage transaction. This proposed requirement is meant to protect against new borrowers not being able to satisfy the QRM tests.

- *Default Mitigation*. The originator of the QRM must also include in the mortgage transaction documents certain requirements regarding the applicable servicing policies and procedures. These policies and procedures must (i) include prompt initiation of activities that mitigate risk of default on the loan, which the Proposed Rules specify would need to commence 90 days after the mortgage loan becomes delinquent, (ii) include provisions to modify the loan in the event that the net present value of the modification exceeds recovery through foreclosure[21], (iii) take into account the borrower's ability to repay and other appropriate underwriting criteria and (iv) contain servicer compensation arrangements that are consistent with the commitment to engage in such loss mitigation procedures. The policies and procedures must also require that the servicer implement procedures to address any loans owned by it or its affiliates and secured by a subordinate lien on the same property that secures the QRM if the related borrower becomes more than 90 days past due. These procedures must be disclosed to investors if the QRM is included in an ABS transaction.[22] The creditor may also not sell, transfer or assign its servicing rights unless the assignee is required to abide by these same required default mitigation commitments.[23]

- *Performing Loans*. Each QRM included in the mortgage pool has to be a performing loan, which means that the borrower could not be 30 days or more past due (in whole or in part) at the time of the closing of the securitization.

- *Depositor Certification*. The depositor would be required to certify that it evaluated the effectiveness of its internal controls in order to ensure that the assets qualify as a QRMs and that such internal supervisory controls are effective. This evaluation must be performed not more than 60 days prior to the cut-off date for the transaction (or similar date). The sponsor is required to provide (or cause to be provided) a copy of this certification to investors in a reasonable time prior to the time of sale and upon request by the SEC or the applicable Federal banking agency.

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[21] The Proposed Rules require that the net present value analysis be done without giving consideration to how such action would benefit any particular class of investors in the related securitization.

[22] The NPR indicates that this requirement is being proposed because the existence of a subordinate mortgage could affect the actions taken to mitigate losses on the related QRM.

[23] In the NPR, it is noted that many of these servicing related requirements may become a part of national servicing standards that would apply to mortgages regardless of whether such mortgages are QRMs, are securitized or held in the portfolio of the institution. These national standards would also apply to servicers that are not affiliates of banks. The NPR predicts that proposed standards will be released later this year.

Repurchases. In the event that it is discovered that one or more loans in a QRM securitization does not meet the QRM definition due to an inadvertent error, the sponsor that relied on the QRM exemption would not lose such exemption if the following conditions are met:

- The depositor must have previously certified that it evaluated the effectiveness of its internal controls with respect to the process for ensuring that the loans were QRMs.
- The sponsor must repurchase the loan that is not a QRM at par plus accrued interest thereon and such repurchase must occur no later than 90 days after the determination is made that such loan does not qualify as a QRM.
- The sponsor must notify (or cause to be notified) all of the investors in the related ABS of the loans that are required to be repurchased, noting the principal amount of the repurchased loans and the cause for such repurchase.

Possible Alternative Approach. In the NPR, the Agencies have requested comment regarding whether an alternative approach to the QRM exemption should be considered. The alternative suggested would create a broader definition of a QRM, including a wider range of mortgages with lower credit quality, but make risk retention requirements stricter for non-QRMs, such as providing less flexibility in how risk is retained (i.e., requiring vertical risk retention or increasing the base risk retention requirement). Under this approach, the QRM standards set forth above would be modified as follows:

- For purchase transactions or rate and term refinancings, the LTV ratio could not exceed 90% (with no restriction on the existence of a subordinate lien at closing on a purchase transaction).
- For cash-out refinancings, the combined LTV ratio could not exceed 75%.
- Required cash down payment on a purchase mortgage could be reduced to (i) 10% (rather than the proposed 20%) of the lesser of the property's market value or purchase price, plus (ii) the closing costs payable by the borrower in connection with the mortgage transaction.
- Borrower's maximum front-end ratio could be increased to (i) 33%, if payments under the mortgage could not increase by more than 20% over the life of the mortgage; or (ii) 28%, if payments under the mortgage could increase by more than 20% over the life of the mortgage.
- Borrower's maximum back-end ratio could be increased to (i) 41%, if payments under the mortgage could not increase by more than 20% over the life of the mortgage; or (ii) 38%, if payments under the mortgage could increase by more than 20% over the life of the mortgage.

- Mortgage guarantee insurance or other types of insurance or credit enhancements provided by third parties could be taken into account in determining whether the borrower met the applicable combined LTV requirement, but such insurance or enhancements would not alter the 90% maximum combined LTV for purchase transactions and rate and term refinancings and 75% maximum combined LTV for cash-out refinancings.

B. ABS Backed By Qualifying Commercial, Commercial Real Estate, or Automobile Loans

The risk retention requirements described above would not apply to an issuance of ABS if all of the assets backing the transaction are commercial loans, commercial real estate (CRE) loans, or automobile loans that satisfy specified underwriting standards. The proposed underwriting standards are meant to ensure that the loans that qualify for the exemption are those that pose a very low credit risk. In addition to the requirements below for each asset class, the depositor must certify that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that the assets collateralizing the ABS meet all of the requirements for such asset class specified below. This evaluation must occur for each issuance of ABS, within 60 days of the cut-off date for the transaction (or similar date). Furthermore, the sponsor must provide (or cause to be provided) the depositor certification to potential investors a reasonable period of time prior to the time of sale and, upon request, to the appropriate Agency.

Underwriting Standards for Qualifying Commercial Loans

Under the Proposed Rules, a commercial loan is defined as "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 (that is, 50% or more) of repayment is expected to be derived from rents collected from persons or entities that are not affiliates of the borrower." For ABS comprised solely of commercial loans to qualify for the risk retention exemption, such loans must meet the underwriting standards specified in the Proposed Rules as summarized below. In addition, the related securitization may not permit for reinvestment periods.

- *Ability to Repay*. The Proposed Rules require the following:
  - The originator must verify and document the financial condition of the borrower as of the end of the borrower's two most recently completed fiscal years.
  - The originator must analyze the borrower's ability to service its overall debt obligations during the next two years, based on reasonable projections. A commercial loan would qualify only if the originator determines that during the borrower's two most recently completed fiscal years and the two-year period after

the closing of such loan, the borrower had, or is expected to have: (1) a total liabilities ratio of 50% or less; (2) a leverage ratio of 3.0 or less; and (3) a debt service coverage ratio of 1.5 or greater.

- Loan payments must be determined based on straight-line amortization of principal and interest that fully amortize the debt over a term not to exceed five years from the origination date. Loan payments must also be required to be made no less frequently than quarterly.
- The Proposed Rules do not require that a commercial loan be secured by collateral. However, if the loan is secured, the originator must be granted a first-lien security interest over the pledged property and the borrower must make certain covenants in the loan agreement designed to protect the value of the collateral as described below.

Note: This requirement has the bizarre effect of allowing unsecured loans meeting all other requirements to qualify for the exemption but not allow secured second-lien loans to so qualify. As most CLOs in the past have had at least some second-lien loans in the collateral pool, this requirement means that CLOs with second-lien loans would be unable to qualify for the commercial loan exemption.

- The primary source of repayment for the commercial loan must be revenue from the business operations of the borrower.
- The loan must be funded within six months prior to the closing of the related securitization transaction.
- At the closing of the securitization transaction, all payments due on the loan must be contractually current.

- *Risk Management and Monitoring Requirements*. In an effort to mitigate default risk during periods of economic stress or when the financial condition of the borrower otherwise deteriorates, the Proposed Rules require the loan documentation for commercial loans to include the following covenants:

  - Covenant to provide the originator (or a subsequent holder) and the servicer with financial information and supporting schedules on an on-going basis (and not less frequently than quarterly);
  - Covenant prohibiting the borrower from retaining or entering into a debt arrangement that permits payments-in-kind;
  - Covenants placing limitations on transfers of any of the borrower's assets, restricting the borrower's ability to create other security interests with respect to any of its

assets or any change in the name, location or organizational structure of the borrower (or any other party that pledges collateral for the loan); and

- Covenants designed to protect the value of any pledged collateral pledged securing the loan by requiring the borrower (and any other party that pledges collateral for the loan) to: (i) maintain insurance protecting against loss on any collateral at least up to the amount of the loan and naming the originator (or any subsequent holder) as an additional insured, loss payee, or similar beneficiary; (ii) pay any taxes, charges, claims and fees where nonpayment could give rise to a lien against any collateral securing the loan; (iii) take any action necessary to perfect or defend the security interest of the originator or any subsequent holder of the loan in the collateral for the commercial loan or the priority thereof, and to defend the collateral against claims adverse to the lender's interest; (iv) permit the originator or any subsequent holder of the loan, and the servicer of the loan, to inspect the collateral and the books and records of the borrower; and (v) maintain the physical condition of any collateral for the loan.

Underwriting Standards for Qualifying CRE Loans

Under the Proposed Rules, a CRE loan is defined as "a loan secured by a property with five or more single-family units, or by nonfarm non-residential real property, the primary source (50% or more) of repayment for which is expected to be derived from: (a) the proceeds of the sale, refinancing, or permanent financing of the property; or (b) rental income associated with the property other than rental income that is derived from any affiliate of the borrower." A CRE loan does NOT include a land development and construction loan (including one-to-four family residential or commercial construction loans), land loans[24], a loan to a real estate investment trust (REIT),[25] or an unsecured loan to a developer.

For ABS comprised solely of CRE loans to qualify for zero risk retention, such loans must meet the underwriting standards specified in the Proposed Rules as summarized below.

- First Lien. Each CRE loan must be secured by a first lien on commercial real estate.

[24] It is unclear whether "land loans" would include loans made to borrowers that ground lease their fee interests and the related ground rent payments serve as the only source of payments on the loan.

[25] Note, however, that loans to special purpose vehicles may not be captured by this exclusion.

- Ability to Repay. The Proposed Rules require the following:
  - The originator must verify and document the current financial condition of the borrower and determine that, based on the previous two years' actual performance, the borrower had, and based on two years of projections, the borrower will have, a debt service coverage (DSC) ratio of 1.7 or greater; provided, however, a CRE loan on a property that has a demonstrated history of stable the operating income (NOI) may have a 1.5 DSC ratio.[26]
  - The CRE loan generally must have a fixed stated interest rate (or adjustable rate if the borrower obtains a derivative product that results in the borrower paying a fixed interest rate).
  - The CRE loan provides for a maturity date that is at least ten years, but not more than 20 years.
  - Loan payments must be (i) no less frequent than monthly and (ii) based on straight-line amortization over a term that does not exceed 20 years.
  - The CRE loan does not (1) permit the borrower to defer principal or interest payments; or (2) contain an interest reserve to fund all or part of a payment on the loan.
- *Loan-to-Value Requirement*. The combined loan-to-value ratio (CLTV) must be less than or equal to 65%; provided, that if the capitalization rate used in the appraisal is less than the 10-year interest rate swap rate plus 300 basis point, the maximum CLTV would be 60%. For purposes of calculating the CLTV, the value of the property will be (1) in the case of an acquisition, the lesser of the purchase price or the estimated market value and (2) in the case of a refinancing, the estimated market value. In each case, estimated market value will be based on an appraisal meeting the requirements set forth below.

[26] To qualify under the lower DSC ratio, the CRE loan must be secured by either (1) a residential property (other than a hotel, motel, inn, hospital, nursing home, or other similar facility where dwellings are not leased to residents) that consists of five or more dwelling units primarily for residential use, and where at least 75% of the CRE property's NOI is derived from residential rents and tenant amenities (such as a swimming pool, gym membership, or parking fees); or (2) commercial nonfarm real property (other than a multi-family property or a hotel, inn or similar property) that is occupied by, and derives at least 80% of its aggregate gross revenue from, one or more "qualified tenants".

A "qualified tenant" is defined as either: (1) a tenant with a triple net lease with a remaining maturity of at least six months who has satisfied all obligations with respect to the property in a timely manner, or (2) a tenant who originally had a triple net lease that subsequently expired and currently is leasing the property on a month-to-month basis, has occupied the property for at least three years prior to the date of origination, and has satisfied all obligations with respect to the property in a timely manner.

- *Valuation of Collateral*. The originator must obtain an appraisal of the real property securing the loan that was performed not less than six months from the origination of the loan by an appropriately state-certified or state-licensed appraiser. The appraisal must give an "as is" opinion of the current market value of such property, using a discounted cash flow analysis.

- *Environmental Assessment*. The originator must conduct an environmental risk assessment of the property and take appropriate steps to mitigate any environmental liability determined to exist based on such assessment.[27]

- *Risk Management and Monitoring Requirements*. The loan documents must contain covenants to facilitate monitoring and managing of the credit risk of the term of the loan, which are generally consistent with covenants in recent ABS deals with CRE loans. The covenants include the following:

  - Covenant to provide the originator (and any subsequent holder) and the servicer with financial statements on an on-going basis, but not less than quarterly.

  - Prohibition on creating other security interests in the collateral, transferring the collateral, or changing the name, location or organizational structure of the borrower (or other party pledging collateral).

  - Requirement that the borrower and other party that pledges collateral to (a) maintain certain insurance, (b) pay taxes, charges or fees that may give rise to a lien on any collateral, (c) take actions to perfect or protect the security interest of the originator (or any subsequent holder), (d) permit inspection of the collateral and books and records, (e) maintain physical condition of the collateral, (f) comply with environmental, zoning, building code, licensing and other laws applicable to the collateral, (g) comply with leases, franchise agreements, condominium declarations, and other documents and agreements, and to not modify any material terms and conditions of such agreements over the term of the loan without the consent of the originator (or any subsequent holder) or the servicer and (h) not materially alter the collateral without certain required consents.

  - Loan documentation must also prohibit the borrower from obtaining a loan secured by a junior lien on any property that serves as collateral for the loan, unless such loan

[27] As noted in the NPR, such measures may include a reduction in the loan amount sufficient to reflect potential losses; however, where the assessment reveals significant environmental hazards, originators are encouraged to reconsider the primary loan decision. The originator can have a qualified third party perform the assessment, but remains responsible for ensuring that appropriate measures are taken to mitigate any risk of loss due to environmental risks.

finances the purchase of machinery and equipment and the borrower pledges such machinery and equipment as additional collateral.

Underwriting Standards for Qualifying Automobile Loans

Under the Proposed Rules, an automobile loan is defined 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."[28] The loan may be for a new or used vehicle.

For ABS comprised solely of automobile loans to qualify for zero risk retention, such loans must meet the underwriting standards specified in the Proposed Rules as summarized below.

- *Ability to Repay*. The Proposed Rules require the following:
  - Borrower must have a monthly debt-to-income ratio of less than or equal to 36%, the determination of which must be documented by the originator.
  - The originator needs to document and verify the borrower's income using payroll stubs, tax returns, profit and loss statements or other similar documentation. The originator also needs to verify the outstanding debts reported on the credit report are incorporated into the debt-to-income ratio calculation.
  - The originator must obtain from the borrower information about all monthly housing payments plus any of the following that are dependent on the borrower's income for payment: (1) monthly payments on all debt and lease obligations, including the monthly amount due on the automobile loan; (2) estimated monthly amortizing payments for any term debt, debts with other than monthly payments, and debts not in repayment (i.e., deferred student loans, interest-only loans); and (3) any required monthly alimony, child support, or court-ordered payments.
- *Loan Terms*. Loans must have a fixed interest rate and the monthly payment must be calculated using straight-line amortization with the first payment due within 45 days of the closing date. Deferred repayment of principal or interest is also prohibited. For new vehicle loans, the maturity date may not exceed 5 years from the closing date and for used vehicle loans, the term of the loan, plus the difference between the current model year and the vehicle's model year, may not exceed 5 years. Physical possession of the vehicle title

[28] An automobile loan does not include (a) any loan to finance fleet sales; (b) a personal cash loan secured by a previously purchased automobile; (c) a loan to finance the purchase of a commercial vehicle or farm equipment that is not used for personal, family, or household purposes; (d) any lease financing; or (e) a loan to finance the purchase of a vehicle with a salvage title.

must also be maintained by the originator (or subsequent holder) or by their agents until payment in full.

- *Reviewing Credit History*. The originator must verify and document, within 30 days of origination, that the borrower is not 30 days or more past due on any debt and has not been 60 days or more past due on any debt within the past 24 months. Originator must also document and verify that the borrower was not a debtor in a bankruptcy proceeding, subject to judgment for collection of any unpaid debt or foreclosure, repossession, deed in lieu of foreclosure, or short sale and hasn't had any other personal property repossessed within the previous 36 months. Similar to what is described above for QRMs, the originator may take advantage of a safe harbor to satisfy this requirement if it obtains a credit report regarding the borrower from at least two consumer reporting agencies and determines based on such information that the borrower meets the credit history requirements set forth above. The safe harbor is not available if the originator obtains a report prior to closing the loan that contains contrary information.

- *Loan-to-Value Ratio*. The originator must document the borrower had a minimum down payment from its own personal funds (and trade-in allowance) that is sufficient to pay the full cost of the vehicle title, tax and registration fees (and any dealer-imposed fees) and 20% of the purchase price of the vehicle. For a new vehicle, the purchase price is calculated as the net amount paid for the vehicle after application of incentive payments or cash rebates, and for a used vehicle the purchase price is the lesser of the actual purchase price or the value of the vehicle (as determined by a recognized automobile pricing agency).

Buy-Back Requirements

If, after the closing of a securitization, it is determined that a loan collateralizing a transaction does not meet the specified standards, the securitizer will not lose the benefit of the exemption so long as the sponsor repurchases the loans determined not to meet the underwriting standards at par plus accrued interest on the loan within 90 days after the determination is made. This buy-back requirement is the same requirement as set forth above for QRMs.

V. Other Exemptions

Under the Proposed Rules, certain types of ABS or securitization transactions would be exempt from the credit risk retention requirements of the Proposed Rules. These additional exemptions are intended to be consistent with, and to implement, the applicable requirements of Section 15G.

A. General Exemptions

Under the Proposed Rules, the risk retention requirements would not apply to the following types of transactions:

- Any securitization transaction that (i) is collateralized solely (excluding cash and cash equivalents) by residential, multifamily or health care facility mortgage loan assets that are insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States or (ii) involves the issuance of ABS that (A) are insured or guaranteed as to the payment of principal and interest by the United States or any agency of the United States; and (B) are collateralized solely (excluding cash and cash equivalents) by residential, multifamily, or health care facility mortgage loan assets or interests in such assets.

  Note: For example, the exemption under clause (i) would apply to loans that are insured or guaranteed by the FHA, the Department of Veterans Administration, or the Department of Agriculture and Rural Development. This exemption implements Section 15G(e)(3)(B) of the Exchange Act. Also, the exemption under clause (ii) would apply to securities guaranteed by the Government National Mortgage Association.

- Any ABS that is collateralized solely (excluding cash and cash equivalents) by loans or other assets made, insured, guaranteed, or purchased by any institution that is subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation.

- Any ABS that is a security 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 registration requirements of the Securities Act.

- Any ABS that meets the definition of a qualified scholarship funding bond, as set forth in Section 150(d)(2) of the Internal Revenue Code of 1986.

- Any securitization that: (i) is collateralized solely (other than cash and cash equivalents) by existing ABS issued in a securitization transaction: (A) for which risk was retained under the Proposed Rules; or (B) that was exempted from the credit risk retention requirements pursuant to the Proposed Rules; (ii) is structured so that it involves the issuance of only a single class of ABS Interests; and (iii) provides for the pass-through of all principal and interest payments received on the underlying ABS (net of expenses of the issuing entity) to the holders of such class.

Note: Most resecuritizations are structured with at least two senior/subordinate classes. Because the proposed exemption restricts resecuritizations to a single pass-through class, multiclass resecuritizations of underlying ABS that were exempt from, or otherwise satisfied, the risk retention requirements would subject the sponsor of such resecuritizations to the risk retention requirements.

In addition, the risk retention requirements would not apply to any securitization transactions if the ABS issued in the transaction are: (1) collateralized solely (excluding cash and cash equivalents) by obligations issued by the United States or an agency of the United States, (2) collateralized solely (excluding cash and cash equivalents) by assets that are fully insured or guaranteed as to payment of principal and interest by the United States or an agency of the United States, or (3) fully guaranteed as to the timely payment of principal and interest by the United States or any agency of the United States.

The Proposed Rules specify that securitization transactions involving the issuance of ABS that are either issued, insured, or guaranteed by, or are collateralized by obligations issued by, or loans that are issued, insured, or guaranteed by, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or a Federal home loan bank will not on that basis qualify for exemption under the Proposed Rules.

Although Fannie Mae and Freddie Mac do not independently qualify for an exemption, the Proposed Rules allow Fannie Mae and Freddie Mac securitizations to be exempt for so long as they are under the conservatorship or receivership of the FHFA with capital support of the United States, as described under "*Permissible Forms of Risk Retention—Treatment of Government Sponsored Enterprises*" above.

B. Additional Exemptions

The federal Agencies with rule writing authority under Section 15G with respect to the type of assets involved may jointly provide a total or partial exemption of any securitization transaction as such Agencies determine may be appropriate in the public interest and for the protection of investors.

The Federal banking agencies and the SEC, in consultation with the FHFA and HUD, may jointly adopt or issue exemptions, exceptions or adjustments for classes of institutions or assets in accordance with Section 15G.

C. Foreign Transactions Safe Harbor

The Proposed Rules would provide a "safe harbor" provision intended for certain foreign transactions if all of the following requirements are satisfied:

- The securitization transaction is not required to be and is not registered under the Securities Act.
- No more than 10% of the dollar value by proceeds (or equivalent if sold in foreign currency) of all classes of ABS Interest sold in the securitization transaction are sold to U.S. persons or for the account or benefit of U.S. persons.
- Neither the sponsor of the securitization transaction nor the issuing entity is: (i) chartered, incorporated, or organized under the laws of the United States, any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States (each, a "**U.S. Jurisdiction**"); (ii) an unincorporated branch or office (wherever located) of an entity chartered, incorporated, or organized under the laws of a U.S. Jurisdiction; or (iii) an unincorporated branch or office located in a U.S. Jurisdiction of an entity that is chartered, incorporated, or organized under the laws of a jurisdiction other than a U.S. Jurisdiction.
- If the sponsor or issuing entity is chartered, incorporated, or organized under the laws of a jurisdiction other than a U.S. Jurisdiction, no more than 25% (as determined based on unpaid principal balance) of the assets that collateralize the ABS Interest sold in the securitization transaction were acquired by the sponsor or issuing entity, directly or indirectly, from: (i) a consolidated affiliate of the sponsor or issuing entity that is chartered, incorporated, or organized under the laws of a U.S. Jurisdiction; or (ii) an unincorporated branch or office of the sponsor or issuing entity that is located in a U.S. Jurisdiction.

The safe harbor described above would not be available with respect to any transaction or series of transactions that, although in technical compliance, is part of a plan or scheme to evade the requirements of Section 15G and the Proposed Rules. In such cases, compliance with Section 15G and the Proposed Rules would be required.

VI. Conclusion

The Proposed Rules would impose new and significant requirements for all sponsors in securitization transactions. Unless a sponsor in a securitization involving asset classes entitled to one of the exemptions is able to develop and maintain underwriting policies and procedures that comply with all of the requirements of such asset-specific exemption, the sponsor (and/or, if applicable, qualifying originators or certain other parties as discussed above) will be required to

satisfy the risk retention requirements of the Proposed Rules. Due to the unexpected and controversial proposal for a premium capture cash reserve account, the Proposed Rules would, and are intended to, make it economically unattractive for a sponsor to structure an ABS transaction that generates a profit payable to the sponsor at closing (e.g., the gross proceeds (less closing costs) from the sale of ABS exceeds the par amount of the ABS Interest issued). While sponsors in CMBS transactions may allocate the risk retention requirement to qualifying third-party purchasers of first-loss positions in the CMBS transaction, that market may be chilled by the Proposed Rules barring such first-loss purchaser from acting as servicer or special servicer unless an independent operator supervises the servicing or sub-servicing role. Hedging, risk-sharing and other transfers of the required retained risk are significantly restricted under the Proposed Rules.

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