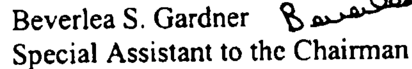
MEMORANDUM TO: The Board of Directors

FROM: Michael H. Krimminger
General Counsel

Beverlea S. Gardner 
Special Assistant to the Chairman

DATE: March 21, 2011

SUBJECT: Notice of Proposed Rulemaking to Implement Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act <u>(Credit Risk Retention)</u>

Proposal: That the of Directors ("Board") of the Federal Deposit Insurance Corporation ("FDIC") approve and adopt for publication in the Federal Register the attached notice of proposed rulemaking (the "NPR" or "proposed rules") titled, Credit Risk Retention. The NPR would implement the credit risk retention requirements of section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). If approved, the overall NPR would be issued on an interagency basis with the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("FRB"), and the U.S. Securities and Exchange Commission ("Commission"). The portions of the NPR addressing residential mortgages, in particular the standards applied for qualified residential mortgages ("QRMs"), will be proposed jointly by the FDIC, OCC, FRB, Commission, along with Federal Housing Finance Agency ("FHFA") and Department of Housing and Urban Development ("HUD") (together, the "Agencies"). All provisions will be subject to a 60-day public comment period.

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Section 941 of the Dodd-Frank Act amends the Securities Exchange Act of 1934 by adding a new section 15G (hereinafter, section 941 shall be referred to as, "section 15G"), which generally requires a securitizer of asset-backed securities ("ABS") to retain not less than 5 percent of the credit risk of the assets collateralizing the ABS issuance, and prohibits the securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain.[1]

Section 15G exempts certain types of securitization transactions from the risk retention requirements and authorizes the Agencies to exempt or establish a lower risk retention requirement for other types of securitization transactions. Of particular note, section 15G exempts securitizations consisting of QRMs, as defined jointly by the Agencies, from the risk retention requirements.[2] In addition, section 15G requires the Agencies to provide for a risk retention requirement of less than 5 percent for an ABS issuance collateralized by residential mortgages, commercial mortgages, commercial real estate ("CRE") loans, or automobile loans, if such loans meet underwriting standards established by the FDIC, FRB, and OCC (the "Federal banking agencies").

As required by section 15G, the proposed rules provide a complete exemption from the risk retention requirements for any ABS that is collateralized solely by QRMs and establish the terms and conditions under which a residential mortgage would qualify as a QRM, including that the originator provide in the mortgage transaction documents certain requirements regarding the adoption of policies and procedures for servicing the mortgage loan. Although the proposed

[1] See 15 U.S.C. § 78o-11(b), (c)(1)(A) and (c)(1)(B)(ii).

[2] See 15 U.S.C. § 78o-11(c)(1)(C)(iii), (4)(A) and (B).

QRM standards have not been publicly released, some issues concerning this proposal have been the subject of active public discussion. For the Board's background, it is useful to refer back to the statutory provisions and the actual proposed rules. The Agencies were instructed by Congress in Section 941 of the Dodd-Frank Act to jointly define QRMs "taking into consideration underwriting and product features that historical loan performance data indicate results in a lower risk of default" such as verification and documentation of income, the ratio of housing and all installment payments, private mortgage insurance, and prohibiting the use of balloon payments and other features that may create payment shock to borrowers. The QRM standards in the NPR address these issues based on the Agencies' thorough review of historical loan performance data available from a variety of sources, including in particular the FRB, the FHFA, and HUD and various studies on the effect of servicing standards that reduce default risk. The QRM underwriting standards focus on the ability to repay relying on: documented income; prudent ratios of housing and all installment payments; amortized payments incorporating taxes, insurance, and any homeowner dues; payment performance history; an 80 percent loan-to-value ("LTV") requirement for purchase transactions; and stable mortgage terms that do not provide for substantial payment shock. The standards do incorporate servicing standards because of the important role that quality servicing plays in avoiding, and mitigating defaults. The standards do not incorporate a role for private mortgage insurance because the available data, controlling for mortgage underwriting standards, did not support inclusion of such insurance as a default risk mitigant. The proposed rules include a specific request for comment on this issue, and encourage commenters to provide historical loan performance data or studies and other factual support, which will be valuable in further testing and refining the QRM standards.

While the NPR provides underwriting standards for QRMs, it does not provide standards for other residential mortgages, which would be subject to a 5 percent risk retention requirement. Instead, the NPR solicits comment on whether the Agencies should develop separate underwriting standards for such loans (in addition to those proposed for QRMs), which would qualify a sponsor for a partial exemption (that is, a risk retention requirement of more than zero but less than 5 percent). The Agencies encourage commenters to identify any underwriting standards that might be appropriate for non-QRM securitizations, as well the amount of the risk retention that should be applied based on those underwriting standards.

The proposed rules also establish conservative underwriting standards for commercial loans, CRE loans, and automobile loans, which are used to support a full exemption from the risk retention requirements, consistent with section 15G. For the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (together, the "Enterprises"), the proposed rules provide that the guarantee of an Enterprise satisfies the risk retention requirement while such entities are operating under FHFA conservatorship or receivership with capital support from the U.S. government.

The proposed rules also provide the following exemptions from risk retention:

- ABS collateralized by obligations issued by, or by assets insured or guaranteed by the U.S. government;
- ABS issued by any State of the United States or any subdivision thereof that is exempt from registration under section 3(a)(2) of the Securities Act of 1933;
- ABS insured or guaranteed by the U.S. government; or
- ABS collateralized by assets made, insured, guaranteed or purchased by institutions supervised by the Farm Credit Administration; or

- ABS that constitute qualified scholarship funding bonds.

The proposed rules also provide a limited exemption for risk retention for single-tranche resecuritizations that do not alter the payment terms and credit risk of the underlying ABS interests. Finally, the proposed rules include a safe harbor with respect to foreign-related transactions.

In order to evaluate options for the appropriate form of risk retention for securitizations that were not exempted from risk retention, the Agencies reviewed extensive data on the historical performance of different options. In the recent financial crisis, many securitizations did require risk retention. However, many securitizers were able to sell the senior bonds for prices that more than covered the amount of any risk retention. This so-called "monetization of the excess spread" was particularly evident in Alt-A securitizations because of the high cash flow available from the bonds while the mortgages performed and the corresponding higher prices paid by bond purchasers. This also meant that the risk retention was illusory in incentivizing behavior because the securitizer received payments for the senior bonds well in excess of the retained credit risk. To address this issue, the proposed rules provide for the creation of a "premium capture" reserve fund, which would be funded by the proceeds of any ABS interests sold at a premium or any interest-only tranche. This premium capture reserve fund, when established, would be a first-loss position and absorb losses on the securitized assets before any of the risk retention options described below. This is a significant innovation because it eliminates the incentive to structure mortgages to maximize their initial cash flow since the excess spread premium will 'thicken' the first-loss cushion held for future losses. These funds would only inure to the benefit of the securitizer if the loans perform and losses do not eliminate

the remaining reserve fund. The "premium capture" reserve fund feature applies to all asset classes and all of the following options for risk retention.

With this background, the proposed rules provide several options for the 'form' that risk retention may use. These options are described in more detail in section II of this memorandum. The options are:

(i) a "vertical slice" option, which requires a securitizer to retain not less than 5 percent of each class of ABS interests issued in the securitization;

(ii) a "horizontal residual interest" option, which requires a securitizer to retain a first-loss position in an amount equal to at least 5 percent of the par value of all ABS interests issued in the securitization;

(iii) a cash reserve fund option, which requires the securitizer to cause to be established and funded an account in an amount equal to at least 5 percent of the par value of all ABS interests issued in the securitization. The account shall be made available to absorb losses on the securitized assets in the same manner and to the same extent as a horizontal first-loss interest;

(iv) an "L-Shaped" option, which is a hybrid approach consisting of risk retention in both a vertical slice and a horizontal residual interest; and

(v) a representative sample option, which requires the securitizer to retain a randomly-selected pool of assets that are materially similar to the assets collateralizing the ABS issuance, measured as 5.264 percent of the unpaid principal balance of the securitized assets.

The proposed rules also include four transaction-specific options:

(i) for securitizations involving a revolving asset master trust (which, for example, is commonly used in securitizations of credit card receivables), a "seller's interest" option, which requires the securitizer to retain no less than 5 percent of the unpaid principal balance of the assets held by the revolving asset master trust;

(ii) for certain asset-backed commercial paper ("ABCP") conduits, the risk retention requirement may be satisfied where the originator-seller(s) retains a horizontal interest in the intermediate securitization vehicles; and

(iii) for commercial mortgage-backed securities ("CMBS"), the risk retention requirement may be satisfied by an unaffiliated third-party purchaser who meets certain conditions.

These options are consistent with past practice in risk retention for different asset types, but include features that improve the alignment of incentives to promote quality underwriting. The "premium capture" reserve fund is an important supplement to promote incentives for quality underwriting and securitization because securitizers, and where permitted orginators, must hold any excess spread funds as a first-loss position in the securitization. Staff believes that this menu approach to risk retention, together with the exemptions for ABS issuances collateralized by QRMs or certain other low credit-risk assets, will help ensure that securitizers retain a meaningful amount of credit risk in a way that minimizes the potential adverse impact of the proposal on the availability and costs of credit to consumers and businesses. Further, by not allowing the allocation of risk to an originator contributing only a small share of assets to the securitized pool, the proposed rules may prevent sponsors with enough market power from pushing their own risk retention obligations onto such originators such as community banks. Moreover, staff believes the proposed rules are consistent with the stated objectives of section

15G, and will foster sound underwriting and prudent risk management practices with respect to loans that are originated for securitization.

Recommendation: That the FDIC's Board adopt the NPR and approve its publication in the *Federal Register* for a 60-day public comment period.

I. Background

When properly structured, securitization can provide additional liquidity to financial institutions by diversifying funding sources and transferring some credit risk to investors. If well-structured, securitization can lower the cost of credit to households and businesses. However, when incentives are not aligned properly and there is a lack of discipline in the origination process, securitization can harm investors, consumers, financial institutions, and the financial system as a whole. Before and during the recent financial crisis, securitization masked credit risks, reduced transparency, and complicated action to mitigate losses and reduce loan defaults. The significant fee and other income generated by securitization led lenders and other financial market participants to focus on origination volume at the expense of viable underwriting. These deficiencies were largely due to the prevalence of the "originate-to-distribute" business model, which rewards volume over asset quality, as lenders retain little or no continuing exposure to loans they originate for securitization.[3]

The risk retention requirements of section 15G are intended to help address these problems by requiring securitizers to retain an economic interest in the credit risk of assets transferred to investors through an ABS issuance. As indicated in the legislative history of section 15G, "When securitizers retain a material amount of risk, they have 'skin in the game,'

[3] See S. Rep. No. 111-176, at 128 (2010).

aligning their economic interest with those of investors in asset-backed securities."[4] By requiring a securitizer to retain a portion of the credit risk of the securitized assets, section 15G provides an incentive for securitizers to monitor and ensure the quality of the underlying assets following the closing of the securitization transaction.

In working jointly with the other Agencies to develop the proposed rules, staff considered the diversity of assets that are transferred for securitization, the structures historically used in securitizations, historical data reflect factors that reduce delinquencies and align incentives for improved underwriting and the various forms in which securitizers currently retain exposure to the credit risk of securitized assets. The proposed rules allow securitizers to choose among various options to satisfy the risk retention requirements, some of which are transaction-specific and recognize the forms of risk retention currently required by the marketplace. The proposed rules also provide for the establishment of a "premium capture" fund to prevent a securitizer from structuring an ABS transaction in a manner that would effectively negate or reduce the risk retention requirement. Exemptions under the proposed rules are designed to facilitate the flow of credit to consumers and businesses on economically viable terms and in a manner that is consistent with the interests of investors. Therefore, in circumstances where the assets collateralizing the ABS satisfy prudential underwriting and other standards established for the applicable asset class, the proposed rules provide an exemption from the risk retention requirement.[5]

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[4] See id. at 129.

[5] See 15 U.S.C. § 78o-11(c)(1)(B)(ii), (e)(1)-(2).

II. Proposed Rules

A. Scope and Applicability

The proposed rules would apply to sponsors of securitizations that involve the issuance of an ABS, which is defined to mean "a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, lease, mortgage, or other secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset. . . ." The proposed risk retention requirements would apply to all ABS offerings irrespective of whether the offering must be registered with the Commission under the Securities Act of 1933.

The proposed rules use the term "ABS interest" to refer to all types of interests or obligations issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest, or residual interest, whose payments are primarily dependent on the cash flows from the collateral held by the issuing entity. The term, however, does not include interests in an issuing entity that are issued primarily to evidence ownership of the issuing entity, such as common stock in the issuing entity.

Section 15G generally directs the Agencies to apply the risk retention requirements of the statute to a "securitizer" of ABS. Section 15G(a)(3) provides that the term "securitizer" with respect to an issuance of ABS includes "(A) an issuer of an asset-backed security; or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer."[6] The proposed rules provide that a "sponsor" of an ABS transaction is a "securitizer" for the purposes of section 15G, and define the term "sponsor" in a manner consistent with the

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[6] See 15 U.S.C. § 78o-11(a)(3).

definition of that term under Commission Regulation AB, which governs registration, disclosure and reporting requirements under the Federal securities laws .[7]

Staff believes applying the risk retention requirement to the sponsor of the ABS is appropriate in light of the active and direct role that a sponsor typically has in arranging a securitization transaction and selecting assets for securitization. In circumstances where two or more entities each meet the definition of sponsor for a single securitization transaction, one of the sponsors must retain the entire amount of credit risk required under the proposed rules; however, each sponsor would be responsible for ensuring compliance with the risk retention requirements.

In addition, the proposed rules permit a sponsor to allocate its risk retention obligations to the originator(s) of the securitized assets in certain circumstances and subject to certain conditions. The proposed rules define the term originator generally to be a person that "creates" an asset that collateralizes an ABS. Only the original creditor under a loan or receivable – and not a subsequent purchaser or transferee – is an "originator" of the loan or receivable for purposes of the proposal.[8]

B. General Risk Retention Requirement

Section 15G generally requires the Agencies to jointly prescribe regulations that require a securitizer to retain not less than 5 percent of the credit risk for any asset that the securitizer, through the issuance of an ABS, transfers, sells, or conveys to a third party, unless an exemption from the risk retention requirements for the securities or transaction is otherwise available (for example, if the ABS is collateralized exclusively by QRMs). Consistent with section 15G, the proposed rules generally would require a sponsor to retain an economic interest equal to at least

[7] The use of the term "sponsor" enhances consistency among rules that affect securitization, including the Commission's Regulation AB, and other rule making under Title IX of the Dodd-Frank Act.
[8] See 15 U.S.C. § 78o-11(a)(3).

5 percent of the aggregate credit risk of the assets collateralizing an issuance of ABS. The 5 percent risk retention requirement established by the proposed rules would be a regulatory minimum; however, the sponsor, originator, or other party to a securitization may need to structure the transaction to include additional exposure to the credit risk of securitized assets in response to the demands of rating agencies, investors, or other market participants.

Staff believes that the proposed risk retention requirement will provide sponsors a meaningful incentive to monitor and control the quality of the securitized assets and help align the interests of the sponsor with those of investors. The proposed risk retention requirements would apply regardless of whether the sponsor is an insured depository institution, a bank holding company or subsidiary thereof, a registered broker-dealer, or other type of federally-supervised financial institution.

Section 15G expressly authorizes the Agencies to determine the permissible forms through which the required amount of risk retention must be held. Therefore, the proposed rules would provide sponsors with multiple options to satisfy the risk retention requirements. The proposed options recognize the various types of assets securitized and the different structures that have developed in the market and, thus, should reduce the potential for the proposed rules to affect negatively the availability and cost of credit to consumers and businesses.

The proposed rules also include disclosure requirements that are an integral part of, and specifically tailored to, each of the permissible forms of risk retention. The disclosure requirements are intended to provide investors with material information concerning the sponsor's retained interests in a securitization transaction and to provide an efficient mechanism to monitor compliance with the risk retention requirements of the proposed rules.

Vertical Risk Retention Option

A sponsor electing the vertical risk retention option must retain at least 5 percent of each class of ABS interests issued in the securitization transaction regardless of the nature of the class of ABS interests (for example, senior or subordinated) and regardless of whether the class of interests has a par value, was issued in certificated form, or was sold to unaffiliated investors. By holding a 5 percent "vertical slice" in an ABS issuance, a sponsor is exposed to 5 percent of the credit risk that each class of investors has to the underlying collateral. A sponsor electing this option would retain an interest in the entire structure of the securitization transaction.

Horizontal Risk Retention Option

Under the proposed rules, a sponsor may satisfy the risk retention requirement by retaining an "eligible horizontal residual interest" in the issuing entity. The required eligible horizontal residual interest is a first-loss exposure in an amount equal to at least 5 percent of the par value of all ABS interests. Accordingly, an interest qualifies as 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 ABS interest is reduced to zero and has the most subordinated claim to payments of both principal and interest by the issuing entity.

Other terms and conditions govern the structure of an eligible horizontal residual interest to ensure that it is not reduced (in principal amount) more quickly than more senior interests, other than through the absorption of losses. For example, the eligible horizontal residual interest generally is not entitled to any unscheduled principal payments before senior ABS interests are paid in full.

Cash Reserve Fund Option

In lieu of establishing an eligible horizontal interest, the proposed rules allow the sponsor to fund a cash reserve account in an amount equal to the eligible horizontal residual interest. The cash reserve account must be maintained by a trustee, and the account documents must provide certain restrictions and limitations to ensure that the sponsor experiences losses on the underlying assets in the same manner, and at the same time, as it would under an eligible horizontal residual interest.

L-Shaped Risk Retention Option

The L-shaped risk retention option is a hybrid approach that combines the vertical and horizontal forms of risk retention by allowing a sponsor to retain (i) not less than 2.5 percent of each class of ABS interests issued in the securitization transaction as the vertical component and (ii) an eligible horizontal residual interest equal to at least 2.564 percent of the par value of all remaining ABS interests (that is, those interests not required to be retained as part of the vertical component). The horizontal residual interest is calibrated to avoid double counting that portion of an eligible horizontal residual interest that the sponsor is required to hold as part of the vertical component, and to ensure that the combined amount of the vertical component and the horizontal component in the aggregate would equal 5 percent.

Representative Sample Option

The representative sample option would allow a sponsor to satisfy the risk retention requirements by retaining a randomly-selected representative sample of assets that is equivalent in all material respects to the securitized assets. A sponsor who elects the representative sample option would be required to retain assets with an unpaid principal balance equal to at least 5 percent of the unpaid principal balance of all of the assets the sponsor identifies for

securitization. To ensure that the representative sample exposes the sponsor to substantially the same aggregate credit risks as investors, the proposed rules require the sponsor to construct a representative sample using a process that meets certain requirements set forth in the proposed rules – for example, the sponsor would be required to test the representative sample for statistical bias and ensure the similarity of the sample and the securitized assets within a specified confidence interval.

The proposed rules are designed to ensure that the sponsor constructs the representative sample in a manner that conforms to the requirements described above and require the sponsor to obtain an agreed-upon procedures report from an independent public accounting firm addressing the policies and procedures for selecting the representative sample. In addition, to prevent servicing of the representative sample in a manner more favorable to the sponsor, both the representative sample and the securitized assets must be serviced by the same entity on a blind-pool basis and under the same contractual standards.

C. Transaction-Specific Risk Retention Options

Revolving Asset Master Trusts

The proposed rules provide a specific risk retention option for securitizations collateralized by assets held in a revolving asset master trust (a "master trust"),[9] such as credit card accounts or dealer floorplan loans. The sponsor of a securitization involving a master trust typically retains what is commonly known as a "seller's interest," which is a direct, shared interest with all of the investors in the performance of the underlying assets or receivables.

The proposed rules would allow a sponsor of an ABS issuance collateralized by assets held in a revolving asset master trust to satisfy the risk retention requirement by retaining a

[9] In general, a revolving asset master trust is authorized to issue more than one series of ABS backed by a single pool of revolving assets.

seller's interest in an amount not less than 5 percent of the unpaid principal balance of all assets held by the master trust. To minimize regulatory arbitrage opportunities, the proposed rules define "revolving asset master trust" and "seller's interest" in a manner that is consistent with their limited usage in revolving asset transactions and existing market practices.

ABCP Conduits

The proposed rules provide a separate risk retention option for an ABCP conduit that is supported by receivables originated by one or more originators and that meets certain other conditions (an "eligible ABCP conduit"). This option is designed to accommodate the special structure of ABCP conduits as well as the manner in which exposure to the credit risk of the underlying assets typically is retained by participants in the securitization chain.

Where an ABCP conduit is fully-supported by a liquidity facility provided by a prudentially-regulated or foreign financial institution, under the proposed rules the sponsor of the conduit may satisfy the risk retention requirement by requiring the originator-seller to retain an eligible horizontal residual interest equal to at least 5 percent of the par value of all interests issued by an intermediate special-purpose vehicle ("SPV"). This option is consistent with existing market practice where the ABCP conduit often purchases a senior interest in the SPV assets while the originator-seller retains a residual first-loss position on the underlying receivables.

The proposed rules include several conditions designed to ensure that this option is available only to the type of single-seller or multi-seller ABCP conduits described above and that it would not be available to entities or ABCP programs that operate as securities or arbitrage programs. The proposal also imposes certain obligations directly on the sponsor in recognition of the key role the sponsor plays in organizing and operating an eligible ABCP conduit. For

example, the proposal provides that the sponsor of an eligible ABCP conduit would be responsible for compliance with the risk retention requirements, approving the originator-sellers, establishing criteria governing eligible assets, approving all interests in the intermediate SPV to be purchased by the eligible ABCP conduit, and generally administering the operation of the ABCP conduit in compliance with the requirements of these proposed rules.

CMBS Issuances

Section 15G provides that, with respect to CMBS, the regulations prescribed by the Agencies may provide for risk retention of a first-loss position by a third-party purchaser that negotiates for the purchase of such first-loss position; holds adequate financial resources to back losses; conducts due diligence on each asset in the asset pool before the issuance of the CMBS; and meets the same standards for risk retention as the securitizer. Therefore, if certain conditions are satisfied, the proposed rules permit a CMBS sponsor to allocate the risk retention requirements to a third-party purchaser who acquires an eligible horizontal residual interest in the issuing entity in the same form, amount, and manner as would be required of the sponsor.

The proposed rules would require the CMBS transaction documents to provide for the appointment of an independent operating advisor (the "Operating Advisor"), who shall have certain powers and responsibilities if the third-party purchaser is the servicer or an affiliate of the servicer having control rights related to such servicing. The Operating Advisor is required to act in the best interest and for the benefit of investors as a collective whole; must be consulted on all major decisions in connection with servicing the securitized assets; must periodically review the actions of the servicer; and may recommend the appointment of a new servicer for the transaction.

Government-Sponsored Enterprises

Under the proposed rules the guaranty provided by an Enterprise (that is a sponsor) would satisfy the risk retention requirements, provided that the Enterprise is operating under the conservatorship or receivership of FHFA with capital support from the U.S. government. Similarly, an equivalent guaranty provided by a limited-life regulated entity that succeeds to the charter of an Enterprise also would satisfy the risk retention requirement if the entity operates under the direction and control of FHFA with capital support from the U.S. government. If either Enterprise or a successor limited-life regulated entity were to begin to operate outside the scope stated in the proposed rules, then the Enterprise or entity would be required to choose a different risk retention option.

D. Premium Capture Cash Reserve Account

Where a sponsor structures a securitization to monetize excess spread on the underlying assets, the proposed rules would capture the amount immediately recognized as a gain on the sale and require the sponsor to place such amount into a separate premium capture cash reserve account. The amount placed into the premium capture cash reserve account would be in addition to the sponsor's risk retention requirement under the menu of options. Funds in the account would be used to cover losses on the underlying assets before any other interest or risk retention option, or any other account of the issuing entity.

E. Allocation to the Originator

Consistent with section 15G, where certain conditions are satisfied, the proposed rules permit a sponsor to reduce its risk retention requirement by the portion of any risk retention assumed by an originator(s) of the securitized assets, provided that such originator contributes at least 20 percent of the underlying assets in the pool. In addition, the sponsor may only allocate

to an originator a risk retention amount that does not exceed the percentage of the securitized assets contributed by the originator. By limiting this option to originators that have originated at least 20 percent of the asset pool, the proposed rules seek to ensure that the originator retains risk in an amount significant enough to function as a meaningful incentive for the originator to monitor the quality of all the assets being securitized (and to which it would retain some credit risk exposure).

F. Hedging, Transfer, and Financing Restrictions

As required by section 15G, the proposed rules prohibit a sponsor from transferring any interest or assets that it is required to retain under the rules to any person other than an affiliate (excluding an issuing entity) whose financial statements are consolidated with those of the sponsor (a "consolidated affiliate"). The proposed rules permit a transfer to one or more consolidated affiliates because the required risk exposure would remain within the consolidated corporate group and, thus, would not reduce the sponsor's financial exposure to the credit risk of the securitized assets.

The proposal also would prohibit a sponsor or any consolidated affiliate from hedging the credit risk the sponsor is required to retain under the rules. However, hedge positions that are not materially related to the credit risk of the particular securitization transaction would not be prohibited under the proposal. Permitted hedges would include positions related to overall market interest rate movements, currency exchange rates, home prices, or of the overall value of a particular broad category of ABS. The proposed rules also would permit hedges tied to securities that are similar to the ABS issuance that is subject to risk retention. There are additional limitations on hedges based on indices that may include one or more tranches from a sponsor's ABS transactions. Staff believes that the hedging prohibitions are consistent with the

requirements of section 15G, while allowing for prudent asset management in the context of a sponsor's overall balance sheet risk management practices.

The proposal also would prohibit a sponsor (and any consolidated affiliate) from pledging as collateral for any obligation any interest or asset that the sponsor is required to retain, unless the obligation is with full recourse to the sponsor or consolidated affiliate.

An originator, originator-seller, or a third-party purchaser who retains credit risk in accordance with the proposed rules must comply with the hedging prohibition to the same extent as the sponsor.

G. QRM Loans

Section 15G provides that the risk retention requirements shall not apply to an ABS issuance collateralized solely by QRMs, which shall be defined jointly by the Agencies, taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default. However, under section 15G, the definition for QRMs shall be no broader than the definition of a qualified mortgage ("QM") under the Truth in Lending Act (TILA) as amended by the Dodd-Frank Act, and regulations adopted thereunder.

Because the sponsor of an ABS that is collateralized solely by QRMs is completely exempt from the risk retention requirement with respect to such securitization, the underwriting standards and product features for QRMs should be sufficient to ensure that such residential mortgages exhibit low credit risk.

To increase transparency and understanding of the QRM standards, the proposed rules incorporate certain definitions and key terms established by HUD and required to be used by lenders originating residential mortgages that are insured by the Federal Housing Administration (FHA). Specifically, the proposed rules incorporate the definitions and standards currently

provided in the HUD Handbook 4155.1 (New Version), Mortgage Credit Analysis for Mortgage Insurance, as in effect on December 31, 2010,[10] for determining and verifying borrower funds and sources for down payment, as well as the borrower's monthly housing debt, total monthly debt, and monthly gross income. This proposed approach provides transparent, uniform and well-known standards for determining whether a residential mortgage loan qualifies as a QRM, without requiring the Agencies to establish and maintain -- and lenders to comply with -- new requirements.

Consistent with section 15G, the proposed rules provide that a sponsor is exempt from the risk retention requirements of the proposed rules with respect to any securitization transaction if all of the securitized assets that collateralize the ABS are QRMs. The proposal would require that, at the closing of the securitization transaction, each such QRM loan must be currently performing (that is, the borrower is no more than 30 days past due).

The proposed rules set forth factors such as maximum LTV ratios, minimum borrower credit history standards, maximum borrower debt-to-income ("DTI") ratios, minimum servicing standards and other factors, which the Agencies believe, taken as a whole, will result in residential mortgages with low default risk. The proposed rules define a QRM as a closed-end first-lien mortgage for a purchase or refinance of a one-to-four family property, at least one unit of which is the principal dwelling of a borrower who satisfies certain credit requirements. For example, under the proposed rules, the borrower's DTI ratio for housing debt would be limited to 28 percent or less, and the DTI ratio for the borrower's total debt could not exceed 36 percent. These DTI limits are consistent with the overall conservative nature of the QRM standards.

[10] See HUD Handbook, available at http://www.fhaoutreach.gov/FHAHandbook/prod/contents.asp?address=4155-1.

The proposed rules also define a set of "derogatory factors" relating to a borrower that, if satisfied, would disqualify a mortgage from qualifying as a QRM. Such derogatory factors include any delinquency or default on debt repayment, bankruptcy, foreclosure, or repossessions. The originator could satisfy the documentation and verification requirements regarding the derogatory factors and borrower credit history by obtaining credit reports from at least two consumer credit reporting agencies, which demonstrate that the borrower meets the specified requirements.

The proposed rules would prohibit QRMs from having, among other features, payment terms that allow interest-only payments or negative amortization. Both fixed-rate and adjustable-rate mortgages may qualify as QRMs so long as borrowers are qualified at the maximum interest rate permitted under an adjustable-rate loan during the first five years and the terms limit the potential for consumer "payment shock" increases by including payment caps of 2 percent in a 12-month period and 6 percent over the full loan term, and the loans do not include any prepayment penalty. In addition, the total points and fees payable by the borrower in connection with the mortgage transaction may not exceed 3 percent of the total loan amount, which would be calculated in the manner provided in FRB Regulation Z.[11]

To ensure that QRMs have low default risk consistent with their complete exemption from risk retention requirements, the QRM definition requires a more traditional down payment or equity contribution. Based on historical loan performance data, the proposed rules include a requirement for a LTV ratio of 80 percent or less for purchase mortgage transactions and a combined LTV ratio of no more than 75 percent on rate and term refinance loans and no more

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[11] See 12 CFR 226.32(a)(1)(ii) and (b)(1).

than 70 percent for cash-out refinance loans. In addition, there are several conditions on the sources of the down payment in connection with a QRM.

QRMs must be supported by written appraisals that conform to the Uniform Standards of Professional Appraisal Practice, the appraisal requirements of the Federal banking agencies, and applicable laws. In addition, QRM loans cannot be assumable by any person who was not a borrower under the original mortgage transaction.

The proposed rules also require the originator of a QRM loan to incorporate into the transaction documents requirements that obligate the creditor to have specified servicing policies and procedures for the QRM loan.

Specifically, the proposed rules would require the transaction documents for a QRM loan to include terms that obligate the creditor of the QRM loan to have servicing policies and procedures that require the initiation, within 90 days after a mortgage loan has become delinquent, of loss mitigation activities, such as loan modification, where the net present value of such activity exceeds the net present value of recovery through a foreclosure proceeding. In selecting among various loss mitigation activities, the creditor shall consider the borrower's ability to repay and other appropriate underwriting criteria, and not whether such activity benefits a particular class of investors in a securitization. The policies and procedures also must obligate the creditor to implement or maintain servicing compensation arrangements that are consistent with the creditor's commitment to engage in such default risk mitigation activities.

A loan modification potentially could affect the status of any subordinate mortgage loan, and the existence of a subordinate mortgage loan could affect the structure of any loss mitigation activity. Therefore, the proposed rules require servicing policies and procedures for a QRM loan with a subordinate lien. The creditor must disclose those procedures or require them to be

disclosed to potential investors within a reasonable period of time prior to the sale of ABS collateralized by such QRM loan.

The proposed rules would require the originator to disclose the servicing policies and procedures to the borrower at or prior to the closing of the mortgage transaction. Finally, to ensure that the provisions remain effective following a sale of the mortgage loan, the proposed rules would prohibit a creditor from transferring the servicing rights for the mortgage loan unless the purchaser, transferee, or assignee of the loan is required to abide by the servicing policies and procedures as if the purchaser, transferee or assignee were the original creditor of the loan.[12]

The proposed rules require that the depositor of the ABS certify that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the ABS are QRMs and has concluded that such internal supervisory controls are effective.[13] Nevertheless, despite the use of robust processes and procedures, it is possible that one or more QRM loans collateralizing an ABS issuance may later be determined to have not satisfied the QRM definition due to inadvertent error. Under the proposed rules, a sponsor would not become ineligible for the QRM exemption if it is determined that, after the closing date, one or more of the mortgages do not meet all of the criteria to be a QRM. However, to maintain the exemption (i) the depositor must have certified as to the effectiveness of its internal supervisory controls, (ii) the sponsor must repurchase the loans determined not to be QRMs from the issuing entity at a price at least equal to the remaining principal balance and

[12] As noted above, the policies and procedures prescribed under the proposed rule require the creditor's procedures with respect to subordinate liens held by the creditor or affiliates on the mortgaged property to be disclosed to potential investors if the creditor subsequently securitizes the QRM. In addition, the Agencies expect the creditor's commitments to have servicing policies and procedures as specified in the proposed rule would be reflected in the servicing agreement(s) for the securitization, which set forth the terms under which the servicer will service the securitized assets, and would thus be disclosed to potential investors in a securitization offering covered by the SEC's Regulation AB.

[13] A "depositor" is defined to mean the entity (the depositor) that deposits the assets that collateralize the ABS with the issuing entity.

accrued interest not later than 90 days after it is determined that the loans do not satisfy the QRM requirements, and (iii) the sponsor must cause prompt notice to be given to holders of the ABS of any loans required to be repurchased.

The proposal requests comment on whether to broaden the definition for QRM to, for example, include mortgages of potentially lower credit quality while making the risk retention requirements stricter for non-QRM mortgages. Under such an alternative, mortgage guarantee insurance or other types of insurance or credit enhancements could be recognized for purposes of determining the LTV ratio.

H. Qualifying CRE, Commercial, or Automobile Loans

Under section 15G, the regulations issued by the Agencies must include underwriting standards for residential mortgages, CRE loans, commercial loans, and automobile loans, as well as any other asset class that the Federal banking agencies and the Commission deem appropriate. These underwriting standards must specify terms, conditions, and characteristics of a loan within such asset class that indicate low credit risk with respect to the loan. Section 15G permits the Federal banking agencies and the Commission to allow a securitizer to retain less than 5 percent of the credit risk of loans within an asset class that meet such underwriting standards ("qualifying CRE, commercial, or automobile loans").

Consistent with section 15G, the proposed rules provide for a zero percent risk retention requirement for ABS issuances collateralized exclusively by qualifying CRE, commercial, or automobile loans. The underwriting standards for qualifying loans are designed to ensure that each loan exhibits relatively low credit risk, and generally are as conservative as the requirements for QRM. In addition, as required under section 15G, staffs of the Federal banking agencies and the Commission are of the view that the proposed exemptions for qualifying loans

help ensure high-quality underwriting standards and encourage appropriate risk management practices by sponsors and originators of assets; improve access of consumers and businesses to credit on reasonable terms; or, are otherwise in the public interest and for the protection of investors.

Following the closing of a securitization transaction, if it is determined that a qualifying CRE, commercial, or automobile loan does not satisfy the proposed underwriting standards the sponsor would not automatically become ineligible for the exemption. However, to maintain eligibility for an exemption, the depositor and the sponsor must satisfy the certification and repurchase requirements described above.

Qualifying CRE Loans

The underwriting standards for qualifying CRE loans focus predominantly on the borrower's ability to repay the loan, whether the originator has obtained a perfected security interest in the collateral that is protected by covenants set forth in the loan agreement, and the combined LTV ratio at the time of origination. In evaluating the borrower's ability to repay the loan, the proposed rules require originators to evaluate the financial condition of the borrower and the sufficiency of any revenue generated by the CRE to cover loan payments. For example, a qualifying CRE loan must (i) with respect to the borrower, satisfy a minimum debt service coverage ("DSC") ratio of 1.7x, or 1.5x for CRE with a demonstrated history of stable net operating income; and (ii) at the time of origination, have a combined LTV ratio of no greater than 65 percent, or 60 percent where the appraisal uses a low capitalization rate. The borrower also must be required to maintain insurance that provides coverage in an amount no less than the lender's interest in the collateral and names the lender as a beneficiary or loss payee.

Qualifying Commercial Loans

The proposed standards for qualifying commercial loans are generally consistent with, but more prudent and conservative than, industry standards for evaluating the financial condition and repayment capacity of a borrower, and include requirements for evaluating the financial condition of the borrower and its ability to repay as well as, for secured commercial loans, covenants regarding the maintenance of, and ability to, re-pledge collateral.

Specifically, under the proposed rules, for an ABS issuance collateralized exclusively by commercial loans to qualify for a zero percent risk retention requirement, the originator must have conducted an analysis of the borrower's ability to service all outstanding debt over the next two years, and have determined that, following origination, the borrower will have a total liabilities ratio of less than or equal to 50 percent, a leverage ratio of no more than 3.0, and a DSC ratio of no less than 1.5. The loan payment amount must be determined based on straight-line amortization of principal and interest over a term no longer than five years from origination, and the primary repayment source for the loan must consist of business revenue of the borrower. The covenants required under the proposed rules generally are designed to prevent the borrower from over-leveraging the collateral or in any way compromising the security interest of the lender.

Qualifying Automobile Loans

For qualifying automobile loans, the proposed rules set forth conservative requirements that are consistent with the proposed underwriting standards for QRMs, which are somewhat more conservative than existing underwriting standards for consumer installment credit. At the time of origination, the borrower's monthly DTI ratio must be less than or equal to 36 percent, and the borrower's credit history must be clear of any delinquency of 30 days or more within the

past 30 days and of any bankruptcy, foreclosure, or similar proceeding within the previous 36 months. The borrower must also meet down-payment requirements, and shall not be permitted to defer principal or interest under the loan documents

I. Statutory Exemptions

Section 15G requires the Agencies to provide a total or partial exemption from the risk retention requirements for certain types of securitization transactions. Consistent with these provisions, the proposed rules exempt from the risk retention (i) residential, multifamily, or health care facility mortgage loan securitizations that are themselves, or that are collateralized by assets that are, insured or guaranteed by the United States or an agency of the United States (other than Fannie Mae, Freddie Mac, and the Federal Home Loan Banks), (ii) securitization transactions that are collateralized solely 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, (iii) ABS 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 and that is exempt from the registration requirements of the Securities Act of 1933 under Section 3(a)(2) of that Act; (iv) ABS that meet the definition of qualified scholarship funding bond under the Internal Revenue Code; (v) ABS collateralized by obligations of the U.S. government (or an agency thereof) or assets that are fully-guaranteed or insured by the U.S. government (or an agency thereof); and (vi) ABS fully-guaranteed or insured by the U.S. government (or an agency of thereof); and (vii) resecuritization transactions that are (1) collateralized solely by tranches of ABS transactions that comply with, or are exempt from, the risk retention requirements of the rules and (2) structured as a single class of ABS interests entitled to the pass-through of principal and interest payments received on the underlying ABS.

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