Orrick White Paper

Credit Risk Retention – Joint Regulatory Proposed Rules

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TABLE OF CONTENTS

Page

Scope of the Proposed Rules **2**
Permitted Forms of Risk Retention **2**
General Risk Retention Options 2
Asset-Specific Risk Retention Options 4
Credit Risk Retention Considerations for Certain Other ABS 5
Disclosure Requirements **5**
Which Party is Required to Retain the Credit Risk? **6**
The Sponsor 6
Multiple Sponsors 6
Allocation to Originators 7
Consolidated Affiliates 7
Premium Capture Cash Reserve Account **7**
Amount Required to be Deposited 8
Anti-Evasion Provision 8
Disclosure 8
Transfer, Hedging and Pledging Restrictions **8**
Permitted Hedging 9
Qualified Residential Mortgages **9**
Determination of QRM Status 9
QRM Definition 9
Qualified Residential Mortgage vs. Qualified Mortgage 11
Servicing Standards and Related Disclosures 11
Originator Verification Requirements 12
Securitization Guidelines 12
Other ABS Exempt from Credit Risk Retention Requirements **13**
Qualifying Commercial Loans 13
Qualifying Commercial Real Estate Loans 14
Qualifying Automobile Loans 14
GSE Securitizations **15**
General Exemptions **15**
Foreign Transactions Safe Harbor **15**

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The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the FDIC, the SEC and the Federal Housing Finance Authority (the Agencies), have jointly proposed a set of rules[1] to implement the credit risk retention requirements of Section 15G of the Securities Exchange Act of 1934, which was added by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The supplementary information that accompanies the proposed rules includes approximately 200 specific questions on which comments are sought. Comments on the proposed rules must be received by June 10.

Scope of the Proposed Rules

Generally, the proposed rules require a sponsor of a publicly registered securitization, or of a private placement, to retain at least 5% of the credit risk related to the securitization and prohibits the transfer or hedging, and restricts the pledge, of the risk that the sponsor is required to retain. No risk retention is required with respect to specified asset classes if all of the underlying loans in a securitization comply with the qualification provisions set forth in the proposed rules for those asset classes, namely for residential mortgages, commercial loans, commercial mortgages and auto loans. Exemptions from the proposed credit risk retention rules are also provided for securitizations of certain federally insured or guaranteed assets, as well as for Freddie Mac and Fannie Mae guaranteed transactions. In addition to the credit risk retention requirement, the proposed rules also require the deposit of amounts into a premium capture cash reserve account when a securitization is structured to monetize excess spread or other premium.

The proposed rules delineate the permitted forms of risk retention, the circumstances in which the sponsor may allocate its risk retention responsibilities to the originator of the loans included in the securitization, the circumstances in which a premium capture cash reserve account is required, restrictions on pledging and prohibitions on hedging or transferring the retained risk, and the definitions of "qualified residential mortgage," "qualifying commercial loan," "qualifying CRE loan" and "qualifying automobile loan".

Permitted Forms of Risk Retention

Unless a transaction is exempt from risk retention requirements as described below, the sponsor would be required to retain a portion of the credit risk of the securitization equivalent to at least 5% of the credit risk of the securitized assets. The retained credit risk may be in the form of any of five risk retention options. The proposed rules also permit additional asset-specific risk retention options for ABCP and CMBS transactions.

General Risk Retention Options

Vertical Risk Retention (§__.4) The sponsor may retain at least 5% of each class of securities issued in the securitization.

Horizontal Risk Retention (§__.5) The sponsor may retain a first-loss position of at least 5% of the par value of all securities issued in the securitization. Until all other securities in the transaction are paid in full, this retained interest may not receive unscheduled principal payments but it may receive interest payments as well as its pro rata share of scheduled principal payments on the underlying assets.

In the alternative, the sponsor may fund a horizontal reserve account, to be held by the trustee for the benefit of the issuing entity, equal to at least 5% of the par value of all securities issued in the securitization. Until all of the issuing entity's securities are paid in full or the issuing entity is dissolved, the reserve account would be used to cover payment shortfalls on the issuing entity's securities. Amounts would be released to the sponsor from the reserve account only (i) when the issuer receives scheduled principal payments on the underlying assets, with the released amount being proportionate to the ratio of the current balance of the reserve account to the remaining principal balance of all ABS interests of the issuer, and (ii) when interest collections are received on permitted investments purchased with amounts in the reserve account.

[1] The proposed rules and supplementary information are available at http://sec.gov/rules/proposed/2011/34-64148.pdf.

Conflict with European Banking Supervisors Directive It should be noted that the proposed rules do not allow for horizontal risk retention to be satisfied through the sponsor's providing credit support, such as a letter of credit or a guarantee. This omission would result in the rules applicable to U.S. financial institutions to differ from those applicable to European banking institutions. In its December 31, 2010 "Guidelines to Article 122a of the Capital Requirements Directive," the Committee of European Banking Supervisors specifically recognized that "synthetic, contingent or derivative means," such as letter of credit, guarantees or similar forms of credit support" can satisfy the "first loss" retention option applicable in Europe (See clauses 45 and 57 in such Directive).[2]

L-Shaped Risk Retention (§__.6) The sponsor may retain a vertical component equal to at least 2.5% of each class of securities issued in the securitization and an additional component which meets the requirements for horizontal risk retention equal to at least 2.564% of the par value of all securities issued in the securitization other than those interests required to be retained as part of the vertical component. The amount of the horizontal component is designed to avoid double counting the 2.5% subordinate interest that the sponsor is required to retain as part of the vertical component and ensures that the combined vertical component and horizontal component would equal 5% of the entire transaction.

Seller's Interest (Revolving Asset Master Trusts) (§__.7) Where a master trust is established to issue more than one series of ABS which are collateralized by a single pool of revolving assets (e.g. credit card receivables or dealer floorplan financings), the sponsor may retain a "seller's interest" equal to at least 5% of the unpaid principal balance of all of the assets held by the issuing entity. The "seller's interest" is an interest (i) in all of the issuing entity's assets that do not collateralize any other securities of that issuing entity, (ii) that, prior to an early amortization event, is pari passu with all other securities of that issuing entity, and (iii) that adjusts for fluctuations in the outstanding principal balance of the securitized assets.[3]

Representative Sample (§__.8) The sponsor may retain a randomly selected representative sample of assets, equal to at least 5% of the unpaid principal balance of all pool assets initially identified for securitization (or 5.264% of the unpaid principal balance of the assets that are ultimately securitized), that is equivalent in all material respects to the securitized assets.

- The Sample Pool At least 1,000 separate assets would be required to be identified for securitization and all assets in the designated pool would be required to be either be retained or securitized.

- The Random Selection Process A sponsor will select a sample of assets from the designated pool using a random selection process which does not take account of any characteristic other than unpaid principal balance. After a representative sample is selected, the sponsor would be required to assess the sample to ensure that the mean of any material quantitative characteristic, and the proportion of any material categorical characteristic, is within a 95% two-tailed confidence interval of the mean or proportion of the characteristics of all assets in the designated pool. If the representative sample does not satisfy this requirement, the random selection process would be required to be repeated until a qualifying sample is selected or another form of risk retention is chosen.

- Agreed Upon Procedures Letter If the representative sample option is selected, the sponsor would be required to obtain an agreed upon procedures letter from an independent public accounting firm. The accounting firm would be required to report on whether the sponsor has the required procedures in place for selecting the assets to be retained, maintaining required documentation and ensuring that the retained assets are not included

[2] http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Application%20of%20Art.%20122a%20of%20the%20CRD/Guidelines.pdf.

[3] The November 23, 2010 ASF comment letter on credit card risk retention requested more flexibility than we see in the proposed rules. For example, the use of different combinations of risk retention forms (in addition to the permitted L-shaped option) and the ability to change the form of risk retention throughout the life of a transaction were requested, but are not permitted in the proposed rules. The ASF also requested that certain typical card transaction structures be counted toward the risk retention requirement, such as the ongoing account owner relationship that sponsors typically maintain, and the retention of servicing obligations by the sponsor or an affiliated entity. These features are also not included in the proposed rules.

in the designated pool of any other securitizations. The sponsor may rely on this report for subsequent securitizations so long as its policies and procedures relating to the representative sample do not materially change.

- Servicing Until all of the securities issued in the related securitization have been paid in full or the related issuing entity has been dissolved, servicing of the assets in the representative sample and in the securitization pool would be required to be performed by the same entity under the same contractual standards, and the individuals responsible for such servicing must not be able to identify an asset as being part of the representative sample or the securitization pool.

Asset-Specific Risk Retention Options

ABCP Conduits (§__.9) Although a sponsor of an ABCP transaction may satisfy its risk retention requirements by complying with any of the general options described above, the proposed rules also provide a risk retention option that is available only for short-term ABCP collateralized by pools of assets and supported by 100% liquidity coverage. This option allows for satisfaction of the risk retention requirement through retention by the originator-seller of each underlying transaction, rather than the sponsor of the ABCP program, of an interest meeting the horizontal risk retention requirements. In these underlying transactions, the originator-seller creates and transfers assets to an intermediate SPV, which then issues a residual interest, which is retained by the originator-seller, and a senior interest, which is purchased by the ABCP conduit. In order to satisfy the risk retention requirement, each originator-seller would be required to retain a residual interest equal to at least 5% of the par value of all interests issued by its related intermediate SPV.

This option is available only to single-seller or multi-seller ABCP conduits if:

- the ABCP conduit is bankruptcy remote from the sponsor and any intermediate SPV through which ABS is sold into the conduit;
- the ABS issued to the ABCP conduit are collateralized solely by assets originated by a single originator-seller;
- all the interests issued by the intermediate SPV are transferred to one or more ABCP conduits or retained by the originator-seller; and
- a regulated liquidity provider has entered into a legally-binding commitment to provide 100% liquidity coverage on the ABCP.

The proposed rules would require that sponsors relying on this option maintain policies and procedures to monitor originator-sellers' compliance with this risk retention option and notify the ABCP investors of any non-compliance. The proposed rules would also require that the sponsor disclose to investors prior to the sale of any ABCP (and to the SEC and the appropriate bank regulator, if any, upon request) the name of each originator-seller retaining risk in the transaction and the form and amount of such risk retention.

This alternative risk retention option available for ABCP programs has generally been viewed as problematic in the ABCP market for several reasons, including (i) many, if not most, ABCP programs could not satisfy all of the technical requirements of this alternative, such as that each pool of assets would be required to have only one originator-seller and that all senior interests in each pool of assets be purchased only by ABCP conduits, (ii) originator-sellers would lose the option of choosing the risk retention requirement most suitable to the pools of assets being securitized since the ABCP alternative risk retention option requires each originator-seller to comply with the horizontal risk retention requirement, and (iii) the disclosure of originator-seller identity is inconsistent with the usual and customary practice in the ABCP market.

CMBS (§__.10) The proposed rules also provide an option specific to CMBS transactions, in addition to the general options discussed above. The risk retention requirement may be satisfied if a third-party purchaser, often referred to as a "B-piece buyer," retains an interest that would satisfy the horizontal risk retention option discussed above and if the following additional conditions are satisfied:

- commercial real estate loans would be required to comprise 95% of the unpaid principal balance of the securitized assets;
- the purchaser would be required to pay for its interest in cash at closing without financing from any transaction party other than an investor;
- the purchaser would be required to review the credit risk of each asset in the pool prior to the sale of any securities by the issuer; and
- the purchaser may not be affiliated with any transaction party other than an investor and cannot have any control rights that are not shared by all other investors. This prohibition extends to servicing and special servicing rights unless an independent operating advisor is appointed.

The sponsor would remain responsible for compliance with the requirements described above. If the sponsor determines that compliance has not been maintained, it would be required to promptly notify the holders of ABS interests issued in the securitization transaction of such non-compliance.

Credit Risk Retention Considerations for Certain Other ABS

Non-Qualifiying Auto Loans; Auto Leases; Dealer Floorplan Loans Securitizations of automobile loans and leases, other motor vehicle loans and leases, dealer floorplan financing facilities and other similar ABS transactions are all generally subject to the minimum 5% risk retention requirement, with the exception of "qualifying automobile loans" as described below. The "horizontal slice" option has been the most commonly used form of risk retention in auto loan transactions, while the "seller's interest" option is often used in dealer floorplan facilities.

Student Loans Student Loan backed ABS (SLABS) are not addressed in detail in the proposed rules. Generally, SLABS will be subject to the 5% risk retention requirement. Most SLABS issuers have used a form of horizontal residual interest risk retention in the past. The only specific student loan related exemption from the risk retention requirements in the proposed rules is for qualified scholarship funding bonds issued by non-profit corporations organized by a State or a political subdivision of a State. (§__.21(a)(4)) The exemption includes SLABS backed by both FFELP and private student loan collateral.

We understand that there will be an effort to obtain an exemption from the risk retention requirements for FFELP backed SLABS. These assets are subject to guarantees of 97%-98% of the principal by state-level agencies and reinsured by the federal government, leaving only a negligible amount of credit risk with the investors.

Disclosure Requirements

For each of the risk retention options, the sponsor is required to disclose to investors within a reasonable time prior to the sale of the securities and, upon request, to the SEC and the appropriate Federal banking agency, if any, the following information:

- the amount of the interests retained and the amount required to be retained on such transaction under the proposed rules;
- the material assumptions and methodologies used to determine the aggregate dollar amount of ABS interests in the transaction;
- (excluding vertical risk retention) a description of the material terms of the retained interest;
- (horizontal risk retention only) a description of the material terms of the horizontal residual interest, such as when losses are allocated to it or when it may receive payments;
- (representative sample only) a description of the material characteristics of the designated pool of assets and the amount of assets included in the representative sample (at the end of each distribution period, the sponsor is also required to disclose to investors a comparison of the performance of the securitized assets and of the representative sample);

- (ABCP only) information about each originator-seller that retains an interest pursuant to the proposed rules and each regulated liquidity provider; and
- (CMBS only) the purchase price paid for the retained interest, information about the third-party purchaser, the representations and warranties concerning the securitized assets and a schedule of any assets that did not comply with the representations and warranties included in the securitization together with their compensating factors.

Which Party is Required to Retain the Credit Risk?

The Sponsor (§__.3(a))

Section 15G requires the promulgation of regulations requiring a "securitizer" to retain credit risk. Section 15G(a)(3) defines "securitizer" as (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.

The Agencies interpret "issuer" as used in prong (A) to mean "depositor," or the entity that deposits the assets that collateralize the ABS with the issuing entity. Noting that prong (B) is substantially identical to the definition of "sponsor" of a securitization transaction in SEC Regulation AB, the proposed rules provide that a "sponsor" of an ABS transaction is a securitizer for purposes of Section 15G, and "sponsor" is defined in a manner consistent with the definition of that term in Regulation AB (i.e., "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").[4]

Accordingly, the proposed rules would apply the risk retention requirements of Section 15G to a sponsor of a securitization transaction, and not to the depositor.

Multiple Sponsors (§__.3(b))

Where two or more entities each meet the definition of sponsor for a single securitization transaction, the proposed rules allow for the credit risk to be retained by one of the sponsors, but each sponsor remains responsible for ensuring that at least one of the sponsors complies with the risk retention requirements.

For example, in a "rent-a-shelf" transaction, both the institution renting the shelf and the registrant could be considered a sponsor. In that case, the two parties could agree that only one party will retain the credit risk, but both parties would be responsible in the event of non-compliance. The proposed rules do not indicate how this responsibility would be divided between the parties.

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[4] Footnote 42 in the supplementary information indicates that, in the CLO context, the CLO manager generally acts as the sponsor by selecting commercial loans to be purchased by an agent bank for inclusion in the CLO collateral pool and then manages the securitized assets. The definition of "sponsor" in the rule references a person who initiates a securitization by "selling or transferring assets, either directly or indirectly," to the issuer. In many CLOs, neither the manager nor an affiliate would own the assets selected by the manager for inclusion in the pool. It is unclear whether footnote 42 is meant to say that the manager's selection of the assets to be purchased by the issuer constitutes "selling or transferring assets". If the manager is determined to be the sponsor of the CLO, unless an exemption applies, the rule would require that it retain credit risk notwithstanding that it did not have a role in the loan origination and did not receive any of the proceeds of the sale of the loans to the issuer.

Allocation to Originators (§__.13)

A sponsor may allocate its risk retention obligations to the originator(s)[5] of the securitized assets in certain circumstances and subject to certain conditions, which would then reduce the sponsor's required risk retention by the portion of the obligation assumed by originators.

An originator may assume such obligations only if it has contributed a significant amount of assets to the securitization (at least 20 percent of the underlying assets) and is restricted to holding no more than its proportional share of the risk retention obligation.

An originator would be required to step into the shoes of the sponsor and fulfill its retention obligations in exactly the same manner the sponsor would have been required to do had such obligation not been transferred.

Notwithstanding the assumption of the risk retention obligations by an originator, the proposed rules provide that the sponsor would still remain responsible for compliance with the risk retention requirements. Further, in the event the sponsor determines that any originator is not in compliance with the proposed rules, the sponsor would be required to promptly notify the holders of ABS interests issued in the securitization transaction of such non-compliance by the originator.

Consolidated Affiliates (§__.14(a))

A sponsor may transfer the retained credit risk to one or more affiliates whose financial statements are consolidated with those of the sponsor.[6]

Premium Capture Cash Reserve Account (§__.12)

Generally, a sponsor that is subject to a credit risk retention requirement is also required to establish and to fund a premium capture cash reserve account if interest-only tranches or premium bonds are issued in the securitization. The stated purpose of this provision is to restrict the sponsor from monetizing excess spread at the outset of a securitization, which could negate the effect of the risk retention provisions.

Amounts in the premium capture cash reserve account would be required to be held by the trustee for the transaction (or other entity performing similar functions) and would be required to be available to cover losses on the underlying assets before such losses are allocated to any other securities in the securitization, including the sponsor's retained interest. Any amounts remaining in the account after all ABS interests in the issuing entity are paid in full or the issuing entity is dissolved may be released.

Amounts in the premium capture cash reserve account may be invested in U.S. Treasury securities with remaining maturities of 1 year or less and in fully insured deposits at one or more insured depository institutions.

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[5] Originator is defined as "a person who, through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security, and sells the asset directly or indirectly to a securitizer (i.e. a depositor or a sponsor)". IS U.S.C. § 780-11(a)(4)

[6] In securitizations where the sponsor is also the seller of the financial assets to the depositor, the sponsor will ordinarily transfer any retained credit risk to a special purpose entity that is a consolidated affiliate, rather than retaining such interests on its own balance sheet, to address true sale considerations.

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Amount Required to be Deposited (§__.12(a))

Sponsors using vertical, horizontal, L-shaped or revolving asset master trust options

The difference (if positive) between:

- the gross proceeds received by the issuing entity from the sale of ABS interests in the issuing entity to persons other than the sponsor (net of closing costs paid by a sponsor or the issuing entity to unaffiliated parties); and
- 95% of the par value of all ABS interests in the issuing entity issued as part of the transaction.

Sponsors using representative sample, ABCP or CMBS third-party purchaser options

The difference (if positive) between:

- the gross proceeds received by the issuing entity from the sale of ABS interests in the issuing entity to persons other than the sponsor (net of closing costs paid by a sponsor or the issuing entity to unaffiliated parties); and
- 100% of the par value of the ABS interests in the issuing entity issued as part of the transaction.

Anti-Evasion Provision (§__.12(c)(1))

For purposes of determining the amount required to be deposited in the premium capture cash reserve account, an amount equal to the par value (or fair market value if there is no par value) of any ABS interest directly or indirectly transferred to the sponsor in connection with the closing of the securitization would be required to be added to "gross proceeds" if (i) the sponsor does not intend to hold the ABS interest to maturity or (ii) the ABS interest represents a contractual right to receive some or all of the interest, and no more than a minimal amount of principal, and has a payment priority senior to the most subordinated class.[7]

Disclosure (§__.12(d))

The sponsor would be required to disclose to investors within a reasonable time prior to the sale of the ABS and, upon request, to the SEC and the sponsor's Federal banking agency, if any, the dollar amount required to be deposited into the premium capture cash reserve account under the proposed rules and any other amounts deposited or to be deposited at closing.

The sponsor would also be required to disclose the material assumptions and methodology used to determine the fair value of any ABS interest that does not have a par value (and that was used in calculating the amount required to be deposited in the premium capture cash reserve account).

Transfer, Hedging and Pledging Restrictions (§__.14)

Section 15G(a)(1)(A) provides that risk retention regulations shall prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that is required to be retained by the securitizer. The proposed rule aims to achieve this general prohibition by:

- prohibiting a sponsor from transferring any interest or assets that the sponsor is required to retain to any person other than a consolidated affiliate;
- prohibiting a sponsor, its consolidated affiliates and the related issuing entity from purchasing or selling a financial instrument, or entering into an agreement, derivative or position, if the payments on the financial

[7] To avoid double counting, the calculation would not include any IO tranche that the sponsor is required to hold in a vertical or L-shaped risk retention structure.

instrument or under the agreement, derivative or position (i) are materially related to the sponsor's retained credit risk or the assets that underlie the related ABS interests, and (ii) reduce or limit the sponsor's financial exposure to its retained credit risk or the assets that underlie the related ABS interests; and

- prohibiting a sponsor or its consolidated affiliates from pledging as collateral for any obligation any interest or asset that the sponsor is required to retain unless such obligation is with full recourse to the sponsor or consolidated affiliate.

Permitted Hedging (§__.14(d))

The proposed rules also expressly identify certain hedging activities that would be excluded from the general prohibition on hedging retained credit risk. The proposed rules would permit a sponsor, a consolidated affiliate or an issuing entity to:

- hedge against movements of market interest rates (but not the specific interest rate associated with the ABS interest that is otherwise considered part of the credit risk) or currency exchange rates; or
- purchase or sell a financial instrument, or enter into an agreement, derivative or position, based on an index of instruments that includes asset-backed securities if (a) the relevant ABS interests included in the index represent no more than 10 percent of the dollar-weighted average of all instruments included in the index; and (b) all classes of ABS interests of which the sponsor is required to retain credit risk that are included in the index represent, in the aggregate, no more than 20 percent of the dollar-weighted average of all instruments included in the index.

Additionally, the supplementary information indicates that hedges related to (i) home prices, (ii) the overall value of a broad category of asset-backed securities or (iii) securities that are backed by similar assets originated and securitized by other sponsors would not be prohibited by the proposed rules by virtue of not being materially related to the credit risk of a particular ABS interest.

The proposed rules would also permit an issuing entity to engage in hedging activities for the benefit of all investors in its asset-backed securities, but only up to an amount that excludes the sponsor's retained credit risk.

Qualified Residential Mortgages (§__.15)

Securitizations consisting solely of qualified residential mortgages (QRMs) are exempt from the risk retention requirements set forth in the proposed rules. The proposed rules set forth underwriting standards and strict qualifications for what it means for an asset to be a QRM in order to ensure that QRMs are of very high credit quality.

Determination of QRM Status

The determination as to whether a mortgage loan is a QRM is made at the time of origination. This allows for a QRM to be modified after securitization without the loss of QRM status.

QRM Definition

General Requirements/Eligibility Criteria

- Perfected first-lien
  - No other recorded or perfected liens on property
  - No use of junior lien ("piggyback mortgage") in conjunction with the QRM to purchase home
- One-to-four family property
- Principal dwelling of borrower
- Maturity date not to exceed 30 years
- Borrower must complete and submit a written loan application which includes an acknowledgment that the information provided in the application is true and correct as of the execution date

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Types of Loans Prohibited

- Loans made to finance the initial construction of a dwelling
- Reverse mortgages[8]
- Temporary or "bridge" loans with terms of 12 months or less
- Timeshare plans[9]

Borrower's Credit History

- Borrower must not be 30 days or more past due on any debt obligation.
- Within the past 24 months, the borrower must not have been 60 days or more past due on any debt obligation.
- Within the past 36 months, the borrower must not have (i) been the debtor in a bankruptcy proceeding, (ii) had property repossessed or foreclosed upon or engaged in a short sale or deed-in-lieu of foreclosure, or (iii) been subject to a federal or state judgment for collection of any unpaid debt.

Payment Terms and Prohibitions

- No interest-only payments
- No negative amortization
- No balloon payments (a scheduled payment that is more than twice as large as any earlier scheduled payment)
- No prepayment penalties
- Regularly scheduled principal and interest payments on the mortgage may not result in an increase of the unpaid principal balance of the mortgage and may not allow the borrower to defer payment of interest or repayment of principal.
- Mortgage may be either fixed rate or adjustable rate.
  - Any adjustable rate mortgage rate increase may not exceed: (i) 200 basis points in any twelve month period and (ii) 600 basis points over the life of the mortgage.

Points and Fees

- The total points and fees payable by the borrower in connection with the mortgage transaction may not exceed three percent of the total loan amount.

Ability to Repay / Debt-to-Income (DTI) Ratios

- No more than 60 days prior to the closing of a mortgage transaction, the originator is obligated to calculate the DTI ratios using the borrower's monthly gross income and either monthly housing debt (to determine the front-end ratio) or total monthly debt (to determine the back-end ratio).
  - Front-End DTI Ratio Limit: 28%
  - Back-End DTI Ratio Limit: 36%
- The originator is also obligated to determine the amount of the monthly first-lien mortgage payment and, in the case of refinancing transactions, the monthly payment for other debt secured by the property (including any open-end credit transaction as if fully drawn) that, to its knowledge, would exist at the closing of the refinancing transaction. These determinations would be based on the maximum interest rate chargeable during

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[8] Reverse mortgages insured by the FHA are separately exempted from the risk retention requirements under the proposed rules. 15 U.S.C. § 78o-11(e)(3)(B).

[9] The term "timeshare plan" means and shall include that interest purchased in any arrangement, plan, scheme, or similar device, but not including exchange programs, whether by membership, agreement, tenancy in common, sale, lease, deed, rental agreement, license, right to use agreement, or by any other means, whereby a purchaser, in exchange for consideration, receives a right to use accommodations, facilities, or recreational sites, whether improved or unimproved, for a specific period of time less than a full year during any given year, but not necessarily for consecutive years, and which extends for a period of more than three years. A "timeshare interest" is that interest purchased in a timeshare plan that grants the purchaser the right to use and occupy accommodations, facilities, or recreational sites, whether improved or unimproved, pursuant to a timeshare plan. 11 U.S.C. § 53(D).

the first five years after the date on which the first regular periodic payment will be due and a payment schedule that fully amortizes the mortgage over the full term of the loan, which cannot exceed 30 years.

Loan-to-Value (LTV) Ratios

- Purchase Mortgages: 80% LTV limit
- Rate and Term Refinance Loans: 75% LTV limit
- Cash-Out Refinance Loans: 70% LTV limit

Down Payment

- The borrower must put down an amount equal to at least the sum of:
  - The closing costs payable by the borrower;
  - 20% of the lesser of (a) the estimated market value of the property as determined by a qualifying appraisal and (b) the purchase price; and
  - The difference (if positive) between the estimated market value of the property and the purchase price.
- Funds must come solely from borrower funds, may not be subject to any contractual obligation by the borrower to repay and may not have been obtained from a person or entity with an interest in the sale of the property (other than the borrower).

Qualifying Appraisal

- The QRM must be supported by a written appraisal performed not more than 90 days prior to closing of the loan that conforms to generally accepted appraisal standards, as evidenced by the Uniform Standards of Professional Appraisal Practice promulgated by the Appraisal Standards Board of the Appraisal Foundation, the appraisal requirements of the Federal banking agencies, and applicable laws.

Assumability

- A QRM cannot be assumable by any person who was not a borrower under the original mortgage transaction.

Qualified Residential Mortgage vs. Qualified Mortgage

Under Section 15G(e)(4)(C), the definition of "qualified residential mortgage" cannot be any broader than the definition of "qualified mortgage" (QM) as defined under Section 129C(c)(2) of the Truth in Lending Act, as amended by the Consumer Financial Protection Act of 2010, and regulations adopted thereunder. To achieve this, in the proposed definition of QRM, the Agencies incorporated the statutory QM standards; also, the Agencies will monitor rules adopted under TILA to define a QM to determine if changes to the QRM definition are necessary. Refer to the attached table for a comparison of the requirements for a QRM and a QM.

Servicing Standards and Related Disclosures (§ __.15(d)(13))

Under the proposed rules, the QRM exemption would require mortgage transaction documents for all QRMs to incorporate provisions that require mortgage lenders to commit to servicing standards with certain mitigation measures that reduce the likelihood of default. The proposed rules do not describe such provisions in detail, but include the following general requirements:

- Loss mitigation action, "such as loan modification or other loss mitigation alternative," should be taken where the estimated net present value of such action exceeds the estimated net present value of foreclosure, without regard to the interests of any particular class of investors in a securitization;

- Mitigation action should take into account borrowers' ability to repay and other "appropriate underwriting criteria";

- Mitigation action should be initiated within 90 days of a QRM becoming delinquent;

- Servicing compensation arrangements should be consistent with the lender's commitment to the required servicing standards;
- The servicing standards should require the lender to implement procedures addressing any whole loan owned by the lender and secured by a subordinate lien on the same property as the QRM, which procedures would be required to be disclosed to potential investors in any asset-backed securities collateralized by such QRM;
- The transfer by a lender of a QRM should be permitted only if the transferee agrees to abide by the required servicing standards; and
- The QRM originator would be required to disclose such mitigation commitments to each borrower at or before closing of the mortgage loan transaction.

The servicing standards required under the QRM exemption are separate from any national mortgage servicing standards that may be developed through other ongoing interagency efforts.

Originator Verification Requirements (§ __.15(d))

Credit History Within 90 days prior to the origination of a mortgage, the originator would be required to verify and document that the borrower satisfied the QRM credit history requirements set forth above.

Originator Safe Harbor If the originator obtains credit reports from at least two national consumer reporting agencies which demonstrate that the borrower satisfies QRM credit history requirements, and the originator keeps copies of the reports in the loan file, the originator will be deemed to have satisfied the verification and documentation requirements (so long as it does not receive a later credit report which indicates that the borrower did not meet the credit history requirements).

DTI Ratios The originator would be required to verify and document the borrower's monthly gross income, monthly housing debt, and monthly total debt in accordance with the verification and documentation standards set forth in the Additional QRM Standards Appendix in the supplementary information[10] (based on standards in the HUD Handbook[11]).

Down Payments The originator would be required to verify and document the borrower's compliance with the down payment requirements in accordance with the verification and documentation standards set forth in the Additional QRM Standards Appendix referred to above.

Securitization Guidelines

A mortgage loan that met the QRM requirements at the time of origination but that is not currently performing at the time of closing of a securitization transaction will not be permitted to be included in an exempt securitization.

Within 60 days prior to the cut-off date of the transaction, the depositor for the securitization would be required to evaluate the effectiveness of its internal supervisory controls for ensuring that all of the assets that collateralize the ABS are QRMs and would be required to certify that it completed the evaluation and that it has determined that its internal supervisory controls are effective.

- A copy of the certification would be required to be provided by the sponsor to potential investors within a "reasonable period of time" prior to the sale of the ABS, and upon request, to the SEC and its appropriate Federal banking agency, if any.

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[10] See page 199 of the supplementary information to the proposed rules.
[11] HUD Handbook can be found at: http://www.fhaoutreach.gov/FHAHandbook/prod/contents.asp?address=4155-1

A sponsor that has relied on the QRM exemption will not lose the exemption, if, after closing of the securitization transaction, it is determined that one or more of the mortgages collateralizing the ABS do not meet all of the QRM criteria so long as:

- the depositor certification was received;
- the sponsor repurchases the loan within 90 days of the determination that the loan does not satisfy the QRM requirements at a price at least equal to the remaining principal balance and accrued interest on the loan; and
- the sponsor promptly notifies all investors of any loan that is required to be repurchased by the sponsor, including the principal amount of the repurchased loan and the cause for such repurchase.

Other ABS Exempt from Credit Risk Retention Requirements

The proposed rules provide for a zero percent risk retention requirement for ABS backed by qualifying commercial real estate, commercial loans and/or automobile loans that meet the underwriting criteria set forth with respect to each asset class.

The stated criteria are conservative, narrowly-tailored standards designed to ensure that the exempted ABS are of very low credit risk. The proposed rules do not provide for a zero percent risk retention requirement for other asset classes, stating that such assets are generally not as homogenous as those enumerated in the proposed rules and therefore not as easily suited to the development of clear bright-line standards.

As is the case with the QRM exemption described above, to qualify for zero percent risk retention, the depositor would be required to have, and certify that it has, effective internal controls in place to ensure compliance with the stated underwriting criteria. If it is determined after closing that any loans did not meet the stated criteria, the sponsor would be required to repurchase such loans within 90 days of the non-compliance determination, at a price at least equal to the remaining principal and interest on the loan. The sponsor would also be required to disclose the principal amount and cause of any such repurchases to investors.

Qualifying Commercial Loans (§ __.18)

A commercial loan under the proposed rules is any secured or unsecured loan to a company or individual for business purposes, with revenue from the borrower's business operations as the primary source of repayment. In order for a commercial loan to be a "qualifying commercial loan" under the proposed rules, it would be required to meet the following underwriting standards:

- the originator would be required to (1) verify and document the financial condition of the borrower as of the end of the borrower's two most recently completed fiscal years and (2) conduct an analysis of the borrower's ability to service its overall debt obligations during the two years following origination, leading to the conclusion that during those periods, the borrower had or is expected to have:
    - A total liabilities ratio of 50% or less;
    - A leverage ratio of 3.0 or less; and
    - A debt service coverage ratio of 1.5 or greater;
    - the loan payments would be required to be determined based on a straight-line amortization of principal and interest that fully amortize the debt over a term not to exceed 5 years; and
- the loan documentation would be required to require payments no less frequently than quarterly over a term not to exceed 5 years.

If the commercial loan is a secured loan, the originator would be required to also obtain a first-lien security interest on the secured property and certain restrictive covenants would be required to be included in the loan agreement regarding the secured collateral and the borrower's other assets.

Qualifying Commercial Real Estate Loans (§__.19)

Under the proposed rules, a commercial real estate (CRE) loan is a loan secured by a property with five or more single-family units or by nonfarm non-residential real property, for which the primary source of repayment is expected to be the proceeds of a sale or financing of the property or rental income associated with the property. Certain related assets, including loans to REITs, unsecured loans and construction loans are excluded from this exempt category. The detailed underwriting criteria required for "qualifying CRE loans" focus on:

- the borrower's ability to repay the loan, as evidenced by:
  - certain required debt service coverage ratios of the borrower;
  - the sufficiency of the CRE property's net operating income;
  - the borrower's ability to service its other outstanding debt obligations;
  - a fixed stated interest rate on the CRE loan (or an adjustable rate that is effectively fixed through the use of derivative products);
  - a prohibition on certain terms that could adversely affect repayment; and
  - straight-line amortization over a term not to exceed 20 years, with payments made at least monthly over a term of at least 10 years;
- a required combined loan-to-value ratio of 65% or less;
- sufficient value of the CRE collateral for recovery (including recent appraisals and environmental risk assessments) and a valid security interest of the originator in such collateral; and
- whether the loan documentation includes appropriate covenants, similar to those required for qualifying commercial loans, to protect the CRE collateral.

Qualifying Automobile Loans (§ __.20)

An automobile loan is defined narrowly in the proposed rules 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, SUV or light-duty truck) for personal use. This definition does not include fleet sales loans, personal cash loans secured by previously purchased vehicles, loans to finance commercial vehicles or farm equipment not used for personal purposes, leases, financings or salvage loans. A "qualifying automobile loan" may be for a new or used vehicle, and would be required to meet detailed underwriting criteria based on:

- the borrower's ability to repay the loan, as evidenced by a monthly debt-to-income ratio of 36% or less, as determined and documented by the originator in accordance with the procedures specified in the proposed rules;
- certain required loan terms, including:
  - a fixed interest rate;
  - straight-line amortization over a term not to exceed 5 years (with shorter terms corresponding to the model year for used vehicles);
  - the first payment due within 45 days of closing; and
  - physical possession of the vehicle title by the originator or subsequent holder of the loan until paid in full;
- verification and documentation of the borrower's credit history within 30 days of origination:
  - borrower cannot be 30 days or more past due on any debt obligation;
  - within the past 24 months, borrower has not been 60 days or more past due on any debt obligation; and
  - within the past 36 months, borrower has not been in bankruptcy or been the subject of other specified adverse credit events;
- cash and trade-in allowance (limited to trade-in value) would be required to be sufficient to pay:
  - title, taxes and registration fees; plus
  - 20% of the purchase price (which is net of incentive payments and cash rebates).

GSE Securitizations (§ __.11)

The proposed rules provide that the full guarantee of timely payments of principal and interest provided by Fannie Mae and Freddie Mac on their securitizations is sufficient to satisfy the credit risk retention requirements of the rule, so long as such entities are operating under the conservatorship or receivership of the FHFA with capital support from the U.S. This provision would also apply to a successor entity under similar circumstances.

General Exemptions (§ __.21)

A general exemption from the proposed rules is made for securitizations of full faith and credit guaranteed mortgages and certain other assets, or for full faith and credit guaranteed securitizations of such assets, for certain Farm Credit Administration related securitizations, for state and municipal guaranteed securitizations, and for certain one class pass-through resecuritizations of outstanding ABS.

Foreign Transactions Safe Harbor (§ __.22)

The proposed rules will not apply to securitizations that are not required to be registered under the Securities Act of 1933, no more than 10% of which are sold to U.S. persons, and where the sponsor and issuer are non-U.S. persons as delineated in the proposed rules.

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Qualified Residential Mortgage vs. Qualified Mortgage (§__.15)

Subject	"Qualified Mortgage"	"Qualified Residential Mortgage"
General Requirements	• Residential mortgage loan	• Closed-end transaction • Purchase or refinance of a 1-4 family property • Principal dwelling of borrower • DOES NOT finance initial construction • NOT bridge loan with term < 12 months • NOT a timeshare • Shall be NO BROADER than "Qualified Mortgage"
Reverse Mortgage Loan	Must meet standards for a qualified mortgage, as set by the Fed	Not allowed
First Lien	No specified requirement	Must be perfected first lien
Subordinate Liens	No specified requirement	If purchase mortgage, no other recorded or perfected liens on the property exist, to the creditor's knowledge at time of closing, upon the closing of the transaction
Original Maturity	Not to exceed 30 years (except as such term may be extended in certain circumstances, such as in high-cost areas)	Not to exceed 30 years
Written Application	No specified requirement	Borrower's written application includes acknowledgement that information is true and correct as of date executed
Credit History	Income and financial resources relied upon to qualify obligors must be verified and documented	Creditor must verify and document that, w/in 90 days prior to closing: • Borrower not currently 30+ days past due on any debt obligation • W/in past 24 months, borrower has not been 60+ days past due on any debt obligation • W/in previous 36 months, borrower has not been a debtor in bankruptcy; has not had personal property repossessed; no 1-4 family property owned by borrower has been subject of foreclosure, deed-in-lieu of foreclosure or short sale Safe harbor if borrower gets at least 2 credit reports satisfying above
Regularly Scheduled Payments	• May not result in increase of principal balance • Except for allowable balloon loans, borrower cannot defer repayment of principal	• May not result in increase of principal balance • Borrower cannot defer payment of interest or repayment of principal
Balloon Payments	• Except as provided below, no scheduled payments more than twice as large as average of the earlier scheduled payments • Fed may provide that QM includes balloon loans that: ➢ Meet all other QM criteria ➢ For which creditor determines	No scheduled payments more than twice as large as any earlier scheduled payment of principal and interest

Subject	"Qualified Mortgage"	"Qualified Residential Mortgage"
	consumer can make all scheduled payments (other than balloon payment) out of income/assets other than collateral ➢UW based on payment schedule that fully amortizes loan over 30 years or less and takes into account all taxes, insurance and assessments ➢Is extended by a creditor operating in predominantly rural or underserved areas, annual resi mortgage loan originations do not exceed specified limit, creditor retains balloon loans in portfolio, and meets asset size thresholds Fed may establish	
Interest Rate Adjustment	No specified requirement	Increase may not exceed • 2% in any 12 month period • 6% over life of mortgage
Prepayment Penalty	Subject to certain limitations under other sections of TILA	Not allowed
Points and Fees	May not exceed 3% of total loan amount; may be adjusted for smaller loans	May not exceed 3% of total loan amount
Debt-to-Income	Must comply with guidelines established by Fed	As of date no more than 60 days prior to closing: • Front-end DTI 28% or less • Back-end DTI 36% or less
LTV	No specified requirement	• Purchase mortgages – at closing, LTV 80% or less • Rate/term refis – at closing, CLTV 75% or less • Cash-out refis – at closing, CLTV 70% or less
Down Payment	No specified requirement	Borrower must provide, at closing, cash down payment at least equal to sum of: • Closing costs; • 20% of lesser of (1) FMV and (2) purchase price; and • Difference b/w (1) purchase price and (2) FMV Must be solely borrower funds, no contractual obligation to repay, not obtained from person with interest in the sale of the property
Appraisal	No specified requirement	Written appraisal of mortgaged property performed no more than 90 days prior to closing by state-certified or – licensed appraiser conforming to generally accepted appraisal standards as evidenced by USPAP, promulgated by Appraisal Standards Board of Appraisal Foundation, appraisal requirements of federal agencies and applicable law

Subject	"Qualified Mortgage"	"Qualified Residential Mortgage"
Assumability	No specified requirement	NOT assumable by anyone not a borrower at closing
Default Mitigation	No specified requirement	Transaction documents must provide for creditor to: • Mitigate if estimated NPV of action > estimated NPV of foreclosure recovery • Take into account borrower's ability to repay, other appropriate UW criteria • Initiate loss mitigation within 90 days after loan becomes delinquent • Maintain servicing compensation arrangements consistent with obligations in first 3 bullet points • Implement procedures for addressing any whole loan owned by creditor or affiliate and secured by sub lien on same property if borrower 90+ days past due • Disclose procedures to investors if first loan collateralizes ABS • Not sell servicing rights unless transferee required to take same measures • Disclose procedures to borrower at or prior to closing
Underwriting Process	• Fixed-rate: UW process based on payment schedule that fully amortizes over the term of the loan, takes into account all taxes, insurance and assessments • Adjustable-rate: same as for fixed, plus UW based on max rate permitted during first 5 years	• Fixed-rate: UW process based on payment schedule that fully amortizes over the term of the loan, takes into account all taxes, insurance and assessments • Adjustable-rate: same as for fixed, plus UW based on max rate permitted during first 5 years • Originator must verify and document borrower's monthly gross income, monthly housing debt and monthly total debt