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CREDIT RISK RETENTION – JOINT REGULATORY PROPOSED RULES

The proposed rules delineate the credit risk retention requirements for securitizations as mandated by the Dodd-Frank Act, the premium capture cash reserve account required for certain securitizations, and the prohibitions of transfers or hedging of the retained risk. The rules also provide exemptions for securitizations of certain high-quality assets, notably "qualified residential mortgages" and certain other ABS backed by qualifying commercial loans, commercial mortgages, or auto loans.

By Howard Altarescu *

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the FDIC, the SEC, HUD, and the Federal Housing Finance Authority (the Agencies), have jointly proposed a set of rules 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 Dodd-Frank Act). The supplementary information that accompanies the proposed rules includes approximately 200 specific questions on which comments were sought. Comments on the proposed rules were originally due by June 10. The comment period has been extended to August 1.[1]

CURRENT STATUS OF PROPOSED RULES

This article provides a high-level summary of the proposed rules. Since the proposed rules were first published in March 2011, securitization industry participants, including issuers and investors in every sector of the market, have carefully studied and developed comprehensive views on the proposals. Industry participants have worked and are working together to provide the regulators with comment letters recommending changes to the proposed rules. These comment letters with which the authors of this article are familiar strive to allow the purposes and principles of the proposed rules to be achieved while allowing securitizations to work efficiently and continue to provide a vital source of financing to businesses of every kind in the United States.

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 prohibit the transfer or hedging, and restrict the pledge, of the risk that the sponsor is required to retain. No risk retention is required with respect to securitizations of residential mortgages, commercial loans, commercial mortgages, or auto loans if all of the underlying assets in a securitization comply with the qualification provisions set forth in the proposed rules for those asset classes.

[1] U.S. Securities and Exchange Commission Release No. 34-64603; File No. S7-14-11.

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IN THIS ISSUE

● **CREDIT RISK RETENTION – JOINT REGULATORY PROPOSED RULES**

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Exemptions from the proposed credit risk retention rules are also provided for securitizations of certain federally insured or guaranteed assets, for Freddie Mac and Fannie Mae guaranteed transactions, and for non-U.S. transactions meeting certain requirements.

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 assets included in the securitization, the circumstances in which a premium capture cash reserve account is required, the restrictions on pledging and prohibitions on hedging or transferring 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 (or another party, as discussed below) 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 one of five risk retention options. The proposed rules also permit additional asset-specific risk retention options for asset-backed commercial paper (ABCP) and commercial mortgage-backed securities (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 securitization 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 issuing entity 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 issuing entity, and (ii) when interest collections are received on permitted investments purchased with amounts in the reserve account.

Conflict with European Banking Supervisors Directive. The proposed rules do not allow for horizontal risk retention to be satisfied by the sponsor providing unfunded credit support, such as a letter of credit or a guarantee. The proposed rules differ from the rules currently applicable to European banking institutions in a number of ways. For example, in its December 31, 2010 "Guidelines to Article 122a of the Capital Requirements Directive," the Committee of European Banking Supervisors specifically recognized that, for European financial institutions investing in, or assuming exposure to, securitizations, a letter of credit, guarantee, or similar forms of credit support can satisfy the "first-loss" retention option applicable in Europe. (See clause 57 in the Directive.)

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.

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 retained or securitized.

- The Random Selection Process: A sponsor would 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 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 a 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[2], 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.

[2] As noted above under "Permitted Forms of Risk Retention – Horizontal Risk Retention," unfunded credit support is not a permissible form of horizontal risk retention under the proposed rules. Unfunded credit support, typically in the form of an unconditional letter of credit, guarantee, or other similar arrangement provided by the financial institution sponsor of the ABCP conduit and supporting a percentage (generally between 5% and 10%) of outstanding ABCP, is the most common form of exposure that sponsors retain with respect to their ABCP conduits.

This option is available only to single-seller or multi-seller ABCP conduits if: (i) the ABCP conduit is bankruptcy remote from the sponsor and any intermediate SPV through which ABS is sold into the conduit; (ii) the ABS issued to the ABCP conduit are collateralized solely by assets originated by a single originator-seller; (iii) all the interests issued by the intermediate SPV are transferred to one or more ABCP conduits or retained by the originator-seller; and (iv) 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 and ensure 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 that (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 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 this alternative option requires each originator-seller to comply with the horizontal risk retention requirement; (iii) requiring conduit sponsors to both monitor and ensure originator-sellers' compliance with the risk retention rules as a condition of compliance with the ABCP alternative risk retention option is inappropriate; sponsors can do no more than include representations and covenants as to risk retention in their underlying transaction documents, and (iv) 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: (i) commercial real estate loans would be required to comprise 95% of the unpaid principal balance of the securitized assets; (ii) the purchaser would be required to pay for its interest in cash at closing without financing from any transaction party other than an investor; (iii) 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 (iv) 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. The prohibition described in clause (iv) above 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-Qualifying 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 the Federal Family Education Loan Program (FFELP) and private student loan collateral.

We understand that there will be an effort to obtain an exemption from the risk retention requirements for all 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 for 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;
- (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 ABS; or (B) a person who organizes and initiates an ABS 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 define "sponsor" 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"). 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.[3]

Multiple Sponsors (§__.3(b)). Where two or more entities each meet the definition of sponsor for a single securitization transaction, the proposed rules would allow for the credit risk to be retained by one of the sponsors, but each sponsor would remain 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.

Allocation to Originators (§__.13). A sponsor may allocate its risk retention obligations to the originator(s) of the securitized assets in certain circumstances and, subject to certain conditions, this allocation 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% 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 as the sponsor would have been required 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

[3] In ABS transactions where there is not an intermediate transfer of assets from a sponsor to an issuing entity, the depositor would be the sponsor for risk retention purposes.

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.

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 one year or less and in fully insured deposits at one or more insured depository institutions.

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

For sponsors using vertical, horizontal, L-shaped, or revolving asset master trust options, the amount required to be deposited is 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. The 95% figure goes to 100% for sponsors using representative sample, ABCP or CMBS third-party purchaser options.

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 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.

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).

Uncertain Scope of Premium Capture Provisions

As drafted, the provisions of the rules with respect to premium capture go beyond what is required under the Dodd-Frank Act because, pursuant to these provisions, a securitizer must retain all proceeds above the par value of ABS issued in a securitization *in addition to* the 5% risk retention requirement. The provisions do not take into account origination costs, and would inhibit a securitizer from hedging interest rates from the time of origination until the time of securitization. Recently it has been suggested that the premium capture provisions were included by the Agencies to ensure that the value of the credit risk a sponsor retains is actually worth 5% of the fair value of ABS issued in a securitization, and were not meant to impose an additional risk retention requirement. Therefore, the calculation described above under "Amount Required to be Deposited" would be based on fair value rather than par value. As this article goes to press, the Agencies have not made an official statement confirming this alternative meaning of the premium capture provisions.

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 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% 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% 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 provided 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. 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 with no other recorded or perfected liens on property and 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; and 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.

Types of Loans Prohibited: loans made to finance the initial construction of a dwelling; reverse mortgages; temporary or "bridge" loans with terms of 12 months or less; and timeshare plans.

Borrower's Credit History: borrower must not be 30 days or more past due on any debt obligation; within the past 24 months, borrower must not have been 60 days or more past due on any debt obligation; and within the past 36 months, 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 Prohibition: 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; and 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, but any adjustable rate mortgage rate increase may not exceed: (i) 200 basis points in any 12 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 3% 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 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; and cash-out refinance loans: 70% LTV limit.

Down Payment: The borrower must put down an amount equal to at least the sum of: (i) the closing costs payable by the borrower; (ii) 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 (iii) 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.

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 that 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 to the proposed rules (based on standards in the HUD Handbook).

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 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.

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: (i) the depositor certification was received; (ii) 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 (iii) 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.

In the proposing release, the Agencies acknowledge that "many prudently underwritten residential mortgage loans will not meet the proposed definition of a QRM." However, in response to the proposed rules, 39 U.S. senators sent a comment letter explaining that they intended to create a broad exemption from risk retention for historically safe mortgage products when they included the QRM exemption in the Dodd-Frank Act, and that the unnecessarily narrow QRM definition would reduce the availability of affordable mortgage capital for otherwise qualified consumers.[4] In addition, a group of 160 representatives submitted a comment letter urging the Agencies to broaden the scope of the definition by including lower down payment loans that have mortgage

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[4] *See* http://www.sec.gov/comments/s7-14-11/s71411-40.pdf.

insurance in the definition of a QRM.[5] On the other hand, Sheila Bair, chairman of the FDIC, has expressed the position that QRMs are meant to be a small exception to the norm for mortgage products, rather than the market standard, which would argue in favor of a narrow QRM definition.

OTHER ABS EXEMPT FROM CREDIT RISK RETENTION REQUIREMENTS

The proposed rules provide for a 0% risk retention requirement for ABS backed by qualifying commercial real estate, commercial loans, and/or automobile loans that meet 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 0% 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 0% 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: (i) a total liabilities ratio of 50% or less; (ii) a leverage ratio of 3.0 or less; and (iii) a debt service coverage ratio of 1.5 or greater.

- in addition, in order to be a qualifying commercial loan, (1) the loan payments would be required to be determined based on a straight-line amortization of principal and interest that fully amortizes the debt over a term not to exceed five years; and (2) the loan documentation would have to require payments no less frequently than quarterly over a term not to exceed five years.

If the commercial loan is a secured loan, the originator also would be required to obtain a first-lien security interest on the pledged property, and to include certain covenants in the loan agreement regarding the collateral.

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 non-farm 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 Real Estate Investment Trusts ("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: (i) certain required debt service coverage ratios of the borrower; (ii) the sufficiency of the CRE property's net operating income; (iii) the borrower's ability to service its other outstanding debt obligations; (iv) a fixed stated interest rate on the CRE loan (or an adjustable rate that is effectively fixed through the use of derivative products); (v) a prohibition on certain terms that could adversely affect repayment; and (vi) 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;

[5] *See* http://www.sec.gov/comments/s7-14-11/s71411-45.pdf.

- 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, lease 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: (i) a fixed interest rate; (ii) straight-line amortization over a term not to exceed five years (with shorter terms corresponding to the model year for used vehicles); (iii) the first payment due within 45 days of closing; and (iv) 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: (i) borrower cannot be 30 days or more past due on any debt obligation; (ii) within the past 24 months, borrower has not been 60 days or more past due on any debt obligation; and (iii) 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 published trade-in value) would be required to be sufficient to pay: (i) title, taxes, and registration fees; plus (ii) 20% of the purchase price (which is net of incentive payments and cash rebates).

GOVERNMENT SPONSORED ENTERPRISE (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 rules, 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.

In the proposing release, the Agencies express their recognition of the need for, and importance of, GSE reform. The Agencies acknowledge that they will have to revisit and potentially modify § __.11 of the rules once the statutory and regulatory framework for GSE reform is finalized. The Obama administration, in a report to Congress, has proposed three alternatives for restructuring the housing finance market. In addition, a bipartisan bill was introduced in Congress in May 2011, and upwards of 14 bills have been introduced or unveiled by Republican representatives in April and May 2011, proposing assorted measures related to GSE reform and also proposing an override of § __.11.

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 would 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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