Understanding The Proposed U.S. Risk Retention Regime
Contents

I. Executive Summary 3
II. What Types Of Transactions Are Covered? 5
III. Who Is Required To Hold The Retained Interest? 6
   A. The Sponsor 6
   B. Originator 6
   C. Other Structures 7
   D. Hedging, transfer and financing restrictions with respect to the retained interest 7
IV. Permissible Forms Of Risk Retention 8
   A. Vertical Risk Retention 8
   B. Horizontal Risk Retention 8
   C. L-shaped Risk Retention 8
   D. Representative Sample 9
   E. Revolving Asset Master Trusts (Seller’s Interest) 9
   F. Asset-Backed Commercial Paper Conduits 9
   G. B-Piece Buyer of Commercial Mortgage-Backed Securities 10
   H. Treatment of Mortgage-Backed Securities guaranteed by government-sponsored enterprises 12
   I. Premium Capture Cash Reserve Account 12
V. Securitizations That Are Exempt From Risk Retention Or Subject To Reduced Risk Retention Requirements. 14
   A. Qualified Residential Mortgages 14
   B. Qualifying Commercial Real Estate Loans 18
   C. Qualifying Automobile Loans 19
   D. Qualifying Commercial Loans 20
   E. Buy Back Requirements 21
VI. Exemptions For Certain Types Of Transactions 22
   A. General Exemptions 22
   B. Safe harbor for certain foreign-related transactions 22
   C. Additional Exemptions 23
Risk Retention Initiatives Table 24
Annex 29
Key Contacts 31
I. Executive Summary

In late March 2011, the Office of the Comptroller of the Currency, Department of the Treasury (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), the Federal Housing Finance Agency (FHFA), and the Department of Housing and Urban Development (HUD) (collectively, the Agencies) approved and released a notice of proposed rulemaking (NPR) setting forth proposed rules to implement the requirements of Section 941(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). Section 941(b) was codified as new section 15G (Section 15G) of the Securities Exchange Act of 1934, as amended (the Exchange Act).

The stated purpose of Section 15G is to provide securitizers with an incentive to monitor and ensure the credit quality of the assets underlying a securitization transaction, and align the interests of the securitizer with the interests of the investor. The method for achieving this stated purpose is the requirement that the securitizer holds at least 5% of the credit risk of each securitized asset (with certain narrow exceptions) for the life of the securitization, which may not be directly or indirectly hedged. The proposed risk retention rules would generally apply to all asset-backed securities (ABS), regardless of whether the offering is registered with the SEC, but it is proposed that certain foreign securitization transactions would benefit from a safe harbor.

This retained risk can be held through one of several identified means:

- vertical slice;
- horizontal slice;
- L-shaped slice; and
- representative sample.

In addition, it is proposed that certain other risk retention structures may be used in the context of specific types of securitizations, such as:

- sponsors of revolving asset master trusts may satisfy their risk retention obligation by retaining a seller’s interest of at least 5% of the total principal balance of the pool assets sharing the same risks as investors, on a proportionate basis;
- sponsors of commercial mortgage-backed securities may satisfy their risk retention obligation by selling a subordinated interest to a third party who agrees to retain such subordinated interest (a horizontal interest); and
- sponsors of asset-backed commercial paper (ABCP) conduits may satisfy their risk retention obligation if each originator-seller retains an eligible horizontal residual interest in each intermediate SPV established by or on behalf of that originator-seller for purposes of issuing interests to the eligible ABCP conduit.

In addition, for interest-only securities and other ABS sold at a premium, the premium would essentially be converted into additional risk retention as a result of the new requirement that such premium be maintained in a premium capture cash reserve account.

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1 We are happy to supply a comparison summary of U.S. and EU risk retention initiatives upon request. Our ABS Regulatory Reform Roadmap online service also provides practical guidance on key regulatory initiatives from a structured finance perspective, including information on the corresponding cross-border considerations. We would be happy to provide access upon request.
Certain securitization transactions will be exempt from, or subject to reduced, risk retention obligations based on asset category, as described in Section V below. Other general exemptions to the risk retention obligations are described in Section VI below.

The NPR is open to public comment until June 10, 2011. The Dodd-Frank Act’s risk retention requirements will become effective (i) one year after the proposed rule becomes effective with respect to mortgage-backed securities and (ii) two years after the proposed rule becomes effective with respect to other ABS. The risk retention requirements, as proposed, would not apply retroactively to ABS issued prior to such date.\(^2\)

\(^2\) Although Dodd-Frank Act is silent as to the retroactive effect of Section 941, the NPR clarifies that Section 15G does not apply to ABS issued before the applicable effective date of the final rules. As a general matter of U.S. administrative law, regulation with retroactive effect requires express statutory authorization. See Bowen v. Georgetown Univ. Hosp., 488 U.S. 204, 208 (1988) (“A statutory grant of legislative rulemaking authority will not, as a general matter, be understood to encompass the power to promulgate retroactive rules unless that power is conveyed by Congress in express terms.”); Rock of Ages Corp. v. Sec. of Labor, 170 F.3d 148, 158 (2d Cir. 1999).
II. What Types Of Transactions Are Covered?³

Under the proposals, retention would be required in the context of a "securitization transaction". This term is defined as "a transaction involving the offer or sale of asset-backed securities by an issuing entity".

An asset-backed security is defined in Section 3(a)(77) of the Exchange Act as:

(A) a fixed-income or other security collateralized⁴ by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including—

(i) a collateralized mortgage obligation;

(ii) a collateralized debt obligation;

(iii) a collateralized bond obligation;

(iv) a collateralized debt obligation of ABS;

(v) a collateralized debt obligation of collateralized debt obligations; and

(vi) a security that the SEC, by rule, determines to be an ABS for purposes of this Section; and

(B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.

Synthetic securitizations are excluded.

While the definition of ABS is very broad, the NPR states that “because the term 'asset-backed security' for purposes of Section 15G includes only those securities that are collateralized by self-liquidating financial assets, 'synthetic' securitizations are not within the scope of the proposed rules.”

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³ The definition of ABS is so broad that it could be interpreted to include certain interests in hedge funds, warehouse structures, and other fund structures that have not been considered asset-backed securities by the market in the past. However the definition would not apply to ABS interests issued in the form of common or preferred stock, limited liability interests, partnership interests, trust certificates or similar interests evidencing ownership of the issuing entity, and the resulting payments, if any, on which are not primarily dependent on the cash flows of the collateral held by the issuing entity.

⁴ Collateral, as defined under the proposed rules, means the assets or other property that provide the cash flow for the ABS interests irrespective of the legal structure of issuance, including security interest in assets or other property of the issuing entity, fractional undivided property interest in the assets or other property of the issuing entity, and leases that convert to cash proceeds from the disposition of property underlying the assets.
III. Who Is Required To Hold The Retained Interest?

Section 15G requires the risk retention requirements be applied to the “securitizer” of ABS. The securitizer is defined 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 NPR states that part (B) of the securitizer definition is the equivalent to the definition of “sponsor” under Regulation AB of the Securities Act of 1933, as amended (the Securities Act). It should be noted, however, that the NPR is not limited to transactions that are registered under the Securities Act and/or subject to the disclosure requirements set out in Regulation AB. The Agencies further interpret “issuer of any asset-backed security” as referring to the “depositor” of the ABS.

The proposed rules permit the transfer by the sponsor of its retained risk to one or more consolidated affiliates so long as such affiliates remain consolidated with the sponsor for accounting purposes.

A. The Sponsor

A sponsor is 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. If there are two or more entities meeting the definition of “sponsor” in a single ABS transaction, then one of the sponsors is required to satisfy the risk retention requirements. Where there are multiple sponsors, each sponsor remains responsible for ensuring that at least one sponsor complies with the requirement. The proposed rules do not allow multiple sponsors to divide the risk retention obligation. In the CLO context, a collateral manager who selects and manages the underlying assets would be considered a sponsor.

B. Originator

An originator is the person who (i) through the extension of credit or otherwise, creates a financial asset that collateralizes an ABS and (ii) sells an asset directly or indirectly to a securitizer.

Subject to the conditions and restrictions discussed below, a sponsor may reduce its required risk retention obligations in a securitization transaction by the portion of risk retention obligations assumed by the originator(s) of the securitized assets, provided that the conditions below are met.

1. Each originator must be the originator of at least 20% of the underlying assets.
2. The risk allocated to each originator must be at least 20%, but not more than the percentage of the underlying assets originated by such originator.

Additional requirements include:

1. The originator will be held to the same requirements with respect to its retained interest as the related sponsor, including the limits on hedging discussed further in Section III.D below.
2. The sponsor and the originator must use either the horizontal or vertical retention method, and both must use the same risk retention method.
C. **Other Structures**

As further discussed herein, different risk retention holding options are proposed to be made available for certain deals including commercial mortgage-backed securities transactions and ABCP conduits. In addition, special rules apply with respect to ABS issued at a premium.

D. **Hedging, transfer and financing restrictions with respect to the retained interest**

Section 15G requires the risk retention regulations to “prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset.” As discussed above, a sponsor can transfer its retained interest to a consolidated affiliate; this prohibition on hedging or transferring the retained interest is also proposed to apply to such affiliates (i.e. if a hedge is improper for the sponsor, no consolidated affiliate could enter into that hedge).\(^5\)

In particular, under the proposals, the sponsor and its consolidated affiliates are prohibited from purchasing or selling a security or other financial instrument, or entering into an agreement (including an insurance contract), derivative or other position, with any other person if:

(i) payments on the security or other instrument are materially related to the credit risk of any interests that the retaining sponsor is required to retain with respect to a securitization transaction or one or more of the particular securitized assets that collateralize the asset-backed securities issued in the securitization transaction; and

(ii) the security or other instrument in any way reduces or limits the financial exposure of the sponsor to the credit risk of the interests that the sponsor was required to retain.

Transactions that hedge risks relating to the ABS other than credit risk, such as overall market movements, interest rate risk or the overall value of a broad category of ABS, are permitted.

Further, the sponsor would be able to acquire hedges tied to an index such as ABX.HE, provided that:

(i) any class of ABS interests in the issuing entity that were issued in connection with the securitization transaction in which the sponsor was required to retain an interest and that are included in the index represented no more than 10% of the dollar-weighted average of all instruments included in the index; and

(ii) all classes of ABS interests in all issuing entities that were issued in connection with any securitization transaction in which the sponsor was required to retain an interest and that are included in the index represent, in the aggregate, no more than 20% of the dollar-weighted average of all instruments included in the index.

In addition, any credit hedging obtained by the issuer of the ABS cannot benefit the holder of the retained interest in a way that limits the sponsor’s financial exposure with respect to the retained risk.

\(^5\) The prohibition on hedging the retained credit risk will have a broad-reaching effect. A consolidated affiliate may be prevented from engaging in transactions that are wholly unrelated to a securitization, but would be viewed as prohibited hedging under this rule. Further, because synthetic securitizations are not covered by the NPR, presumably a sponsor could hedge 100% of its credit risk in the underlying assets through a synthetic securitization, but neither it nor any consolidated affiliate could engage in a transaction that would be viewed as hedging its retained credit risk.
IV. Permissible Forms Of Risk Retention

As noted above, the proposals refer to various risk retention holding options that a sponsor can use to satisfy the requirement that it retains at least 5% of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction, or, under certain circumstances, 5% of the unpaid principal balance of all assets held by the issuer. The sponsor will be required to report the amount and type of risk retention with respect to each ABS transaction to investors, the SEC and the sponsor’s appropriate Federal banking agency (if any).

A. Vertical Risk Retention

A sponsor would satisfy its risk retention requirement by holding a 5% interest in each class of ABS interests (regardless of whether or not any such interest is certificated, and including any beneficial or residual interest, provided that the payment of such interest depends on the cash flows from the underlying assets), measured in each case by par value (if any), fair value, and number of shares or units.

B. Horizontal Risk Retention

A sponsor would satisfy its risk retention requirement by holding an "eligible horizontal residual interest" that provides the sponsor with first-loss exposure to all ABS interests equal to 5% of the par value of all ABS interests issued as part of the securitization transaction. In order to qualify, the residual interest must be allocated all losses on the securitized assets until the par value of the residual interest is reduced to zero, it must have the most subordinate claim with respect to payments of interest and principal, and, until all other ABS interests in the issuing entity have been paid in full, it is not permitted to receive any principal payments other than its current proportionate share of scheduled principal payments. As an alternative to retaining an eligible horizontal residual interest, the sponsor may satisfy the horizontal risk retention option by funding a cash reserve account equal to 5% of the par value of all the ABS interests issued as part of the transaction. Such account must bear the first loss on the securitized assets in the same manner as the residual interest and meet certain other requirements with respect to the ability of the trustee (as holder of the account) to invest amounts held in the account and limiting the circumstances in which amounts can be withdrawn from the account.

C. L-shaped Risk Retention

L-shaped risk retention combines the vertical and horizontal risk retention options. The sponsor would maintain 2.5% of a vertical component (i.e. of each class of ABS interests) and 2.564% of a horizontal component (taking into account the par value of all ABS interests other than those required to be retained as part of the vertical component). Each component would function in the same manner, and be subject to the same requirements, as the vertical and horizontal risk retention holding options described above.

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6ABS interests (1) include any type of interest or obligation issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest or residual interest, payments on which are primarily dependent on the cash flows of the collateral owned or held by the issuing entity; and (2) excludes common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests that: (i) are issued primarily to evidence ownership of the issuing entity; and (ii) the resulting payments, if any, which are not primarily dependent on the cash flows of the collateral held by the issuing entity.

7It is unclear how a sponsor is required to calculate the par value of any derivative instrument.

8Unfortunately, the proposed rules do not permit a sponsor to satisfy the horizontal risk retention requirements by retaining a combination of a residual interest and a cash reserve account which together equals 5% of all ABS interests.
D. **Representative Sample**

A sponsor may satisfy its risk retention requirement by retaining a randomly selected representative sample of assets that is equivalent in all material respects to the securitized assets. The retained assets must equal 5% of the “designated pool” (based on the unpaid principal balance of all assets initially identified for inclusion in the pool). The representative sample and the securitized assets must come from the same “designated pool” (i.e. designated by the sponsor). The designated pool must contain 1,000 separate assets for securitization. The representative sample will equal $5/95$ths ($5.264\%$) of the aggregate unpaid principal balance of the securitized assets.

The securitizer must use a random selection process to create the representative sample. The methodology for selection is not proposed, but once the representative sample is created, the sample must be tested to confirm that, for each material characteristic of the assets, the mean of any quantitative characteristic, and the portion of any characteristic that is categorical in nature of the sample of assets randomly selected from the designated pool are within a 95\% two-tailed confidence interval of the mean or proportion, respectively, of the same characteristic of all the assets in the designated pool.

The sponsor will be required to maintain policies and procedures for (i) identifying and documenting the material characteristics of the assets in the designated pool; (ii) selecting assets randomly from the designated pool for inclusion in the representative sample; (iii) testing the randomly selected sample of assets in the designated pool; (iv) maintaining, until all ABS interests are paid in full, documentation that clearly identifies the assets included in the representative sample; and (v) prohibiting, until all ABS interests are paid in full, assets in the representative sample from being included in the designated pool of any other securitization transaction. Further, the sponsor will be required to hire an independent public accounting firm to confirm that such policies and procedures are being followed.

E. **Revolving Asset Master Trusts (Seller’s Interest)**

Solely with respect to securitizations of revolving lines of credit, such as credit card accounts and dealer floorplan loans, a sponsor could satisfy the risk retention requirement by holding a seller’s interest in the master trust equal to 5\% of the principal balance of all of the assets held by the issuing entity (the Seller’s Interest). However, other types of securitizations structured as master trusts, such as UK residential mortgage-backed master trusts and CLO master trusts, or other transactions that include reinvestment but whose underlying collateral does not consist of revolving lines of credit, would not be considered a “revolving asset master trust” for purposes of the NPR.

F. **Asset-Backed Commercial Paper Conduits**

This Section applies only to sponsors of ABCP conduits that issue short-term ABCP (having a maturity of nine months or less) collateralized by receivables or loans and supported by a liquidity facility that provides 100\% liquidity coverage from a regulated institution. This risk retention option would not be available to entities or ABCP programs that operate as securities or arbitrage programs, such as SIVs.

Single-seller and multi-seller ABCP conduits are typically structured such that an “originator-seller” will sell the eligible loans or receivables to an intermediate, bankruptcy-remote special purpose vehicle (SPV) established by the originator-seller. The credit risk of the receivables transferred to the intermediate SPV then typically is separated into two classes: (i) a senior interest and (ii) a residual interest retained by the originator-seller.
Subject to meeting certain requirements set out below, a sponsor of an ABCP securitization transaction would satisfy its base risk retention requirement with respect to the issuance of ABCP by an eligible ABCP conduit if each originator-seller retains an eligible horizontal residual interest in each intermediate SPV as described above. The eligible horizontal residual interest retained by the originator-seller must equal at least 5% of the par value of all the interests issued by the intermediate SPV. Accordingly, each originator-seller would be required to retain credit exposure to the receivables sold by that originator-seller to support issuance of the ABCP.

This risk retention option is available only if the sponsor (i) establishes the eligible ABCP conduit, (ii) approves each originator-seller permitted to sell assets, directly or indirectly, to the eligible ABCP conduit, (iii) establishes criteria governing the assets that the originator-seller is permitted to sell to the intermediate SPV, (iv) approves all interests in the intermediate SPV purchased by the eligible ABCP conduit, (v) administers the eligible ABCP conduit by, among other things, monitoring the interests in any intermediate SPV acquired by the eligible ABCP conduit and the assets collateralizing those interests and (vi) maintains and adheres to policies and procedures for ensuring that the conditions for satisfying the risk retention requirements have been met.

An eligible ABCP conduit must meet each of the following criteria:

1. the issuing entity must be bankruptcy-remote or otherwise isolated for insolvency purposes from the sponsor and any intermediate SPV;
2. the ABS issued by an intermediate SPV to the issuing entity must be collateralized solely by assets originated by a single originator-seller;
3. all the interests issued by an intermediate SPV must be transferred to one or more ABCP conduits or retained by the originator-seller; and
4. a regulated liquidity provider must have entered into a legally binding commitment to provide 100% liquidity coverage (in the form of a lending facility, an asset purchase agreement, a repurchase agreement, or similar arrangement) to all the ABCP issued by the issuing entity by lending to, or purchasing assets from, the issuing entity in the event that funds are required to repay maturing ABCP issued by the issuing entity.

G. B-Piece Buyer of Commercial Mortgage-Backed Securities

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

A sponsor of a commercial mortgage-backed security (CMBS) may satisfy its risk retention requirements if a third-party purchaser (commonly referred to as a B-Piece Buyer) acquires an eligible horizontal residual interest provide certain conditions are satisfied.
The conditions are as follows:

1. the B-Piece Buyer must retain the eligible horizontal residual interest in the securitization in the same form, amount, and manner as would be required of the sponsor under the horizontal risk retention option;

2. at least 95% of the total unpaid principal balance of the securitized assets in the securitization transaction are commercial real estate loans;

3. the B-Piece Buyer must pay for the first-loss subordinated interest in cash at the closing of the securitization without financing being provided, directly or indirectly, from any other person that is a party to the securitization transaction (including, but not limited to, the sponsor, depositor, or an unaffiliated servicer), other than a person that is a party solely by reason of being an investor;

4. the B-Piece Buyer must perform a review of the credit risk of each asset in the pool prior to the sale of the ABS. This review must include, at a minimum, a review of the underwriting standards, collateral, and expected cash flows of each commercial loan in the pool;

5. the B-Piece Buyer may neither (i) be an affiliate of any other party to the securitization nor (ii) have any control rights in the securitization (including, but not limited to, acting as servicer or special servicer) that are not collectively shared by all the other investors in the securitization, except that the B-Piece Buyer may be affiliated with one or more originators originating less than 10% of the unpaid principal balance of the securitized assets and may act as, or be an affiliate of, a servicer for any of the assets if the underlying securitization transaction documents provide for the appointment of an operating advisor, as further described below;

6. a sponsor will be required to disclose to potential investors a reasonable time before the sale of ABS and, upon request, to the SEC and the sponsor’s appropriate Federal banking agency (if any) the name and form of organization of the B-Piece Buyer, a description of the B-Piece Buyer’s experience in investing in CMBS, and any other information regarding the B-Piece Buyer or its retention of the eligible horizontal residual interest that is material to investors in light of the circumstances of the particular securitization transaction; and

7. any B-Piece Buyer acquiring an eligible horizontal residual interest under this option must comply with the hedging, transfer and other restrictions applicable to such interest under the proposed rules if the B-Piece Buyer was a sponsor who had acquired the interest under the horizontal risk retention option.

The proposed prohibition on the B-Piece Buyer having control rights related to servicing is intended by the Agencies to address the potential conflict of interest that could arise between the B-Piece Buyer and senior certificate holders. However, a B-Piece Buyer could act as servicer, subject to certain conditions, if the underlying securitization transaction documents provide for the appointment of an independent operating advisor that (i) is not affiliated with any other party to the

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9 Further, the sponsor will be required to disclose the amount of the eligible horizontal residual interest that the B-Piece Buyer will retain (or has retained) in the transaction (expressed as a percentage of ABS interests in the issuing entity and as a dollar amount); the purchase price paid for such interest; the material terms of such interest; and the amount of the interest that the sponsor would have been required to retain if the sponsor had retained an interest in the transaction pursuant to the horizontal menu option. The material assumptions and methodology used in determining the aggregate amount of ABS interests of the issuing entity, including any estimated cash flows and the discount rate used, must also be included in the disclosure. The proposed rules would require that the sponsor provide, or cause to be provided, to potential investors the representations and warranties concerning the securitized assets, the schedule of any securitized assets that are determined not to be compliant with such representations and warranties, and what factors were used to make the determination that a securitized asset should be included in the pool notwithstanding that it did not comply with such representations and warranties, such as compensating factors or a determination that the exception(s) were (was) not material.
securitization, (ii) does not directly or indirectly have any financial interest in the securitization other than in fees from its role as operating advisor, and (iii) is required to act in the best interest of, and for the benefit of, investors as a collective whole. If the B-Piece Buyer or its affiliate is a servicer for the securitization, the transaction documents would also need to require that the operating advisor (i) has the ability and responsibility to ensure that it could effectively fulfill its duties, (ii) is responsible for reviewing the activities of such servicer and for issuing a report on a periodic basis regarding such servicer's compliance with the servicing standards provided in the transaction documents and (iii) has the authority to recommend that such servicer be replaced if the operating advisor, in its sole discretion, determines that such servicer has failed to comply with the servicing standards provided in the transaction documents and that such recommendation will result in the removal of such servicer unless a majority of each class of certificate holders votes to retain such servicer. The Agencies believe that the appointment of an operating advisor meeting the specified requirements mitigates the potential conflict of interest between the B-Piece Buyer and the senior certificate holders by minimizing the ability of the B-Piece Buyer, as servicer, to manipulate cash flows through servicing.

H. Treatment of Mortgage-Backed Securities guaranteed by government-sponsored enterprises

So long as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), and their successors, if any (jointly, the Enterprises) are operating under the conservatorship or receivership of FHFA, the guaranty provided by an Enterprise will satisfy the risk retention requirements with respect to the mortgage-backed securities issued by such Enterprise.

If either Enterprise or a successor limited-life regulated entity were to begin to operate other than as provided in the proposed rules, that Enterprise or entity would no longer be able to avail itself of this risk retention option.

The proposals indicate that the hedging and financing prohibitions of the proposed rules will not apply to an Enterprise while operating under such conservatorship or receivership.

I. Premium Capture Cash Reserve Account

Many securitizations include at their closing one or more interest-only tranches (which may have a nominal value assigned to it, but do not have a par value) or that are sold at a premium for amounts in excess of their par value. By selling premium or interest-only tranches, the securitizer seeks at closing to monetize the excess spread generated by the securitized assets. The Agencies suggest that by monetizing the excess spread before the performance of the securitized assets could be observed and unexpected losses realized, sponsors could reduce the impact of any retained interest. The Agencies further suggest that this creates incentives to maximize securitization scale and complexity, and encourage aggressive underwriting. Therefore, if a sponsor structures a securitization to monetize the excess spread at closing, the proposed rule would “capture” the premium or purchase price received on the sale of the tranches that monetize the excess spread and would require the sponsor to place such amounts into a separate “premium capture cash reserve account.” Such captured amount would be held in addition to any other risk retention requirement.

10 The NPR notes that, under the proposed rules, the transaction documents would need to require that, if the servicer is the B-Piece Buyer or its affiliate, the servicer consult with the operating advisor in connection with, and prior to, any major decision related to the servicing of the securitized assets, including, without limitation, any material modification or waiver of any provision of a loan agreement or any foreclosure upon the underlying property.
The Agencies acknowledge that as a result of the proposed rule very few securitizations would be structured in a manner that seeks to monetize the excess spread.

Specifically, under the proposal:

1. A sponsor retaining credit risk under the vertical, horizontal, L-shaped, or revolving asset master trust options will be required to establish and fund (in cash) at closing a premium capture cash reserve account in an amount equal to the difference (if a positive amount) between:
   
   (i) the gross proceeds received by the issuing entity from the sale of the 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
   
   (ii) 95% of the par value of all the ABS interests in the issuing entity issued as part of the transaction. The 95% of the par value amount is designed to take into account the 5% interest that the sponsor is required to retain in the issuing entity under each of these options.

2. A sponsor retaining risk using a representative sample, or the ABCP or CMBS B-Piece options of the proposed rules, would have to fund (in cash) at closing a premium capture cash reserve account in an amount equal to the difference (if a positive amount) between:

   (i) the gross proceeds received by the issuing entity from the sale of the ABS interests to persons other than the sponsor (net of the closing costs described above); and
   
   (ii) 100% of the par value of the ABS interests in the issuing entity issued as part of the transaction. In these cases, the proposal uses 100% (rather than 95%) of the par value of the ABS interests issued because the relevant menu options do not require that the sponsor itself retains any of the ABS interests issued in the transaction and, accordingly, potentially all of such interests could be sold to third parties.

To prevent any evasion of these rules, the proposed rules require the retaining sponsor to add to the “gross proceeds” amount that is used to calculate the amount (if any) that must be placed in the premium capture cash reserve account an amount equal to the par value of any ABS interest (or the fair value of the ABS interest if it does not have a par value) in the issuing entity that is directly or indirectly transferred to the sponsor in connection with the closing of the securitization transaction and that (i) the sponsor does not intend to hold to maturity; or (ii) represents a contractual right to receive some or all of the interest, and no more than a minimal amount of principal payments received by the issuing entity, and that has a priority of payment of interest (or principal, if any) senior to the most subordinate class of interests in the issuing entity. The condition in (i) above is designed to capture proceeds from the interests that the sponsor retains at closing but expects to sell to third parties after closing. The ABS interests retained and expected to be held to maturity by the sponsor increase the sponsor’s exposure to the credit risk of the underlying assets, thus mitigating the concerns of a sponsor trying to evade the risk retention requirements.

In addition, in order to avoid allowing the sponsor to divert the excess spread at the top of the waterfall and retaining such cash flow, the proposal requires that the value of any interest-only tranche that the sponsor retains at closing be included in the calculation of the premium capture reserve account (regardless of whether the sponsor intends to hold it to maturity) if such tranche has priority of payment senior to the most subordinate class of interests in the issuing entity.

The sponsor will be required to describe the dollar amount the sponsor was required to place in the account and the actual amount the sponsor will deposit (or has deposited) in the account at closing and the material assumptions and methodology for calculating such amount.
V. Securitizations That Are Exempt From Risk Retention Or Subject To Reduced Risk Retention Requirements.

Section 15G requires the issuance of regulations containing underwriting standards for “residential mortgages, commercial mortgages, commercial loans, auto loans, and any other class of assets that the Federal banking agencies and the SEC deem appropriate” that specify loan terms, conditions and characteristics indicative of low credit risk. Where any such “low credit risk” underwriting standards are met for securitized assets, Section 15G of the Exchange Act allows a sponsor to retain “less than 5% of the credit risk” in the securitized assets.

The NPR sets out proposed underwriting standards for (a) residential mortgages, (b) commercial mortgages, (c) auto loans and (d) commercial loans. It refrains from identifying additional asset classes for which underwriting standards are to be prescribed since “… the asset classes specified in Section 15G … capture a predominance of all ABS issuances by dollar volume where the underlying pool is comprised of relatively homogeneous assets …” and “… many of the other types of ABS issuances are collateralized by assets that exhibit significant heterogeneity, or assets that by their nature exhibit relatively high credit risk.”

The NPR proposes a 0% credit risk retention requirement for any securitization transaction in which the securitized assets meet the underwriting standards prescribed by the NPR. The NPR explains that the prescribed underwriting standards (summarized below) are “very conservative.” The Agencies were concerned that imposing a credit risk retention requirement between 0% and 5% for assets meeting the prescribed underwriting standards may not provide sufficient incentives for securitizers to allocate the resources necessary to ensure that the securitized assets meet such underwriting standards, given the significant compliance costs that may be incurred in meeting such retention requirements and providing the required disclosure to investors.

A. Qualified Residential Mortgages

An ABS transaction backed by residential mortgage loans would be exempt from the risk retention requirements if:

(i) all of the securitized assets that collateralize the ABS transaction are Qualified Residential Mortgages (QRM)s;12

(ii) none of the securitized assets that collateralize the ABS transaction are other ABS;

(iii) each QRM collateralizing the ABS is currently performing as of the closing of the ABS transaction; and

11 The proposed regulations set forth detailed eligibility criteria that a residential mortgage must meet in order for securitizations with respect to such mortgages to be exempt from the risk retention requirements. Beyond that, however, “[t]he Agencies do not propose to establish additional underwriting standards for residential mortgages that would be different from those set forth in the [qualified residential mortgage] standards.” We note that the proposed regulations explicitly spell out underwriting, product, and other standards for commercial mortgages, auto loans, and commercial loans.

12 In order to minimize any potential for conflicts between the QRM standards in the NPR and the standards for Qualified Mortgages (QMs) that will be ultimately proposed under the Truth in Lending Act, as amended by the Dodd-Frank Act (TILA), the Agencies have proposed to incorporate many QM requirements into the QRM requirements and apply those standards strictly in order to ensure that, consistent with Section 15G, the definition of a QRM is not broader than the definition of a QM. The Agencies will monitor the rules for QMs adopted under TILA to assess whether any changes to the definition of QRM are necessary to ensure it is no broader than the QM definition.
(iv) the depositor certifies that it has evaluated the effectiveness of its internal supervisory controls for verifying that the loans are QRMs and that it has determined such controls are effective.  

1. **QRMs – Generally**

The underwriting and product feature criteria for a residential mortgage loan to qualify as a QRM (the **Eligibility Criteria**)

relate to:

(v) the borrower’s ability and willingness to repay;

(vi) the borrower’s credit history;

(vii) the borrower’s downpayment amount and sources of funds;

(viii) the LTV ratio;

(ix) the form of valuation used in underwriting;

(x) the type of mortgage; and

(xi) the owner-occupancy status of the related property.

2. **QRMs – Eligibility Criteria**

Reverse mortgages, loans for timeshares, construction loans, or bridge loans (12 months or less) and other loans for temporary financing are excluded from potential QRM status. The Eligibility Criteria comprise the following requirements:

(i) **First lien.** First-lien on a one-to-four family property to be purchased or refinanced.

(ii) **Junior lien.** No junior lien is permitted for purchases but is allowed for refinancings (subject to certain combined LTV limits).

(iii) **Maturity.** Original maturity equal to or less than 30 years.

(iv) **Application.** Written application, in which the borrower acknowledges that the information in the application is true and correct and that civil liability and criminal penalty may result from any misrepresentation (intentional or negligent).

(v) **Credit history**. The creditor must verify within 90 days prior to the closing of the mortgage transaction that:

(1) the borrower is not currently 30 days or more past due on any debt obligation;

(2) the borrower has not been 60 days or more past due on any debt obligation within the past two years; and

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13 The depositor’s certification must be performed within 60 days prior to the pool cut-off date, and a copy of the certification must be provided to potential investors prior to the sale of the ABS and, upon request, to the Commission and the depositor’s appropriate Federal banking agency, if any.

14 The Agencies are not using a credit score threshold such as FICO as part of the QRM definition because “such a standard would require reliance on credit-scoring models developed and maintained by privately owned entities and such models may change materially at the discretion of such entities.” There may also be inconsistencies across the various credit-scoring models used by consumer reporting agencies, as well as among different scoring models used by a single provider. Instead, the Agencies propose the following requirements, which are designed to be a reasonable proxy for credit score thresholds associated with low delinquency rates.
(3) the borrower has not, within the past three years, been subject to any bankruptcy proceeding or judicial proceeding for collection of unpaid debt, had personal property repossessed, or had any real estate subject to foreclosure or short sale.

(vi) **Safe harbor**: The creditor does not have to verify the borrower’s credit history per the above if, within 90 days before closing, it obtains credit reports from at least two national consumer reporting agencies that compile data on a nationwide basis showing that the borrower meets such requirements and such reports are kept with the loan file. However, the safe harbor is unavailable if the creditor obtained an additional credit report before closing of the mortgage transaction indicating that the borrower did not meet the credit history requirements.

(vii) **Payment terms**. Payment terms that allow or impose negative amortization, interest-only payments, a balloon payment or prepayment penalties will disqualify a mortgage loan from QRM status. The loan would need to provide for regularly scheduled principal and interest payments that would not result in an increase in the principal balance of the loan. The borrower would not be permitted to defer interest or principal payments. Fixed-rate and adjustable-rate payment terms are allowed, but adjustments may not exceed 2% in any year, and 6% over the life of the loan.

(viii) **Points and fees**. The total points and fees payable by the borrower cannot exceed 3% of the loan amount.

(ix) **Debt-to-income ratios**. The borrower must satisfy the following two debt-to-income (DTI) ratios, each calculated in accordance with the standards set forth in the NPR and as of a date no more than 60 days prior to the closing of the mortgage transaction:

1. **Front-end DTI ratio**: The borrower’s monthly mortgage payment may not exceed 28% of the borrower’s monthly gross income.
2. **Back-end DTI ratio**: The borrower’s total monthly debt may not exceed 36% of the borrower’s monthly gross income.

The creditor will be required to verify and determine the monthly gross income, monthly mortgage payment and total monthly debt, each in accordance with the Additional QRM Standards Appendix\(^\text{15}\) attached to the NPR.

(x) **Loan-to-value ratio**.

1. **Purchases**: The LTV ratio must not exceed 80% at closing.
2. **Rate and term refinancings**: The combined LTV ratio must not exceed 75%.
3. **Cash-out refinancings**: The combined LTV ratio must not exceed 70%.

(xi) **Downpayment**. The funds used to make the downpayment must come solely from borrower funds which the borrower does not have to repay, and must not have been obtained from any other person or entity with an interest in the sale of the property. The borrower must provide a cash downpayment in amount equal to the sum of (1), (2) and (3) below:

1. closing costs;
2. 20% of the lesser of (a) the estimated market value of the property by a qualifying appraisal and (b) the purchase price; and
3. the positive difference (if any) between the purchase price over the estimated market value.

\(^{15}\) The standards set out in the Additional QRM Standards Appendix are based on the HUD Handbook.
(xii) **Appraisal.** The creditor must obtain a written appraisal of the property that was performed within 90 days prior to the closing by an appraiser that (a) is state-licensed or state-certified, (b) complies with the generally accepted appraisal standards under the Uniform Standards of Professional Appraisal Practice (U.S. PAP), (c) complies with the appraisal requirements of the Federal banking agencies and (d) complies with applicable laws.

(xiii) **Assumability.** The loan must not be assumable by any person who was not a borrower under the loan at closing.

(xiv) **Default mitigation.** The creditor must commit to servicing policies and procedures\(^\text{16}\) under the borrower’s loan documents that:\(^\text{17}\)

1. mitigate the risk of default (by taking certain actions such as loan modifications) in the event the estimated net present value resulting from such action exceeds the estimated net present value of recovery through foreclosure, and without regard to the interests of any class of investors in a securitization;
2. take into account the borrower’s ability to repay and other appropriate underwriting criteria in such loss mitigation actions;
3. initiate loss mitigation activities within 90 days after the loan becomes delinquent (if the delinquency has not been cured);
4. implement or maintain servicing compensation arrangements consistent with the foregoing duties;
5. implement procedures for addressing any whole loan owned by the creditor (or any of its affiliates) and secured by a subordinated lien on the same property that secures a first mortgage loan if the borrower becomes 90 days past due on the first mortgage loan;
6. if the first mortgage loan will collateralize any ABS, require the creditor to disclose in the mortgage transaction documents the procedures in (5) above or require them to be disclosed to potential investors within a reasonable period of time prior to the sale of the ABS; and
7. prohibit the creditor from selling, transferring or assigning servicing rights for the loan unless the agreement requires the purchaser, transferee or the new servicer to abide by the same default mitigation commitments made by the creditor.

3. **Possible alternative approach**

The NPR indicates that the Agencies are seeking feedback on an alternative approach to risk retention in the context of a deal backed by QRMs. In particular, the proposals refer to an alternate approach based on a broader definition of QRMs to allow mortgages of potentially lower credit quality. However, consistent with the Agencies’ goal of incentivizing the origination of high credit quality assets, such a broadening would entail stricter risk retention requirements for non-QRMs, which may include limitations on how sponsors retain risk for non-QRMs (for example, a base risk retention requirement greater than 5%.

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\(16\) These servicing policies and procedures may soon apply to all mortgage loans – not just in the context of Section 15G – as part of a broader effort among Federal regulatory agencies, including some of the Agencies, to develop national mortgage servicing standards applicable to all servicers of residential mortgages. In addition to default mitigation policies, a national standard could take into account the quality of customer service provided throughout the life of a mortgage, the processing and handling of customer payments, foreclosure processing, operational and internal controls, and servicer compensation and payment obligations. The participating agencies expect to request comment on proposed standards later this year.

\(17\) The creditor must have disclosed the following commitments to the borrower no later than the closing of the mortgage transaction.
or mandatory vertical risk retention). The Agencies appear to be willing to lower the bar for QRMs so long as they concomitantly disincentivize the origination of non-QRMs in equal measure.

The Eligibility Criteria for QRMs could be broadened in the following specific ways:

- Combined LTV ratio limit of 90% for purchase transactions or rate and term refinancings (subordinate liens are permitted).
- Combined LTV ratio limit of 75% for cash-out refinancings.
- Cash down payment on a purchase transaction could be reduced to (1) 10% (rather than the proposed 20%) of the lesser of the purchase price or market value of the property, plus (2) the closing costs payable by the borrower.
- Maximum front-end DTI ratio could be increased to (1) 33%, if mortgage payments could not increase by more than 20% over the life of the mortgage or (2) 28% if mortgage payments could increase by more than 20% over the life of the mortgage.
- Maximum back-end DTI ratio could be increased to (1) 41%, if mortgage payments could not increase by more than 20% over the life of the mortgage or (2) 38%, if mortgage payments could increase by more than 20% over the life of the mortgage.
- Credit enhancement such as mortgage guarantee insurance or other types of insurance provided by third parties could be taken into account in determining LTV requirements, but such credit enhancement or insurance would not alter the 90% maximum combined LTV for purchase transactions and rate and term refinancings and 75% maximum combined LTV for cash-out refinancings.

B. Qualifying Commercial Real Estate Loans

The underwriting standards for qualifying commercial real estate loans focus on (a) the borrower’s ability to repay the loan, (b) the value of, and the originator’s security interest in, the collateral, (c) the loan to value ratio and (d) whether the loan documents include collateral protection covenants.

Emphasis is placed both on the sufficiency of the commercial real estate property’s net operating income (less replacement reserves to support interest and principal payments over the life of the commercial real estate loan) and the financial ability of the borrower to repay any other outstanding debt obligations. The underwriting standards would thus require that the borrower have a debt service coverage ratio of 1.7 or greater. A lower debt service coverage ratio of 1.5 may be allowed for a loan with a demonstrated history of stable net operating income so long as that loan is secured by either (a) a residential property (other than a hotel, motel, inn, hospital, nursing home, or other similar facility where dwellings are not leased to residents) that consists of five or more dwelling units primarily for residential use and where at least 75% of the property’s net operating income is derived from residential rents and tenant amenities or (b) commercial nonfarm real property that is occupied by, and derives at least 80% of its aggregate gross revenue from one or more “qualified tenants.”

The underwriting standards would also require the originator of a qualifying commercial real estate loan to determine the borrower’s ability to service other outstanding debt obligations (without considering the net operating income generated from

18 A “qualified tenant” is defined as a tenant that (1) is subject to a triple net lease (i.e., a lease pursuant to which the lessee is required to pay rent as well as taxes, insurance, and maintenance expenses associated with the property) that is current and performing with respect to the property, or (2) was subject to a triple net lease that has expired, currently is leasing the property on a month-to-month basis, has occupied the property for at least three years prior to closing, and is current and performing with respect to all obligations associated with the property. (All outstanding triple net leases must have a remaining maturity of at least six months, unless the tenant leases the property on a month-to-month basis as described above.)
the commercial real estate) by verifying that the borrower has satisfied all its debt obligations over a minimum lookback period of two years and conducting an analysis of the borrower’s ability to service all of its outstanding debt obligations over the two years following origination of the commercial real estate loan (based on reasonable projects that include the new debt obligation).

The NPR recognizes that a commercial real estate loan’s credit risk is dependent on the commercial real estate that serves as the loan collateral. The Agencies thus propose that for a commercial real estate loan to be exempt from the credit risk retention requirement the originator must determine whether the purchase price of the property reflects its current market value so as to ensure adequate collateralization, and whether the borrower has sufficient equity in the property to incentivize such borrower to continue payment of the loan obligation even during an economic downturn or insufficiency of the property’s net operating income. The proposed rules would also require the originator to conduct an environmental risk assessment of the commercial real estate property that serves as collateral and take appropriate measures to mitigate any risk of loss to the value of the property.

The NPR proposes requiring a general combined loan to value ratio of less than or equal to 65% for qualifying commercial real estate loans. However, where the capitalization rate used in the appraisal of a commercial real estate property is less than the ten-year interest rate swap rate plus 300 basis points, the maximum combined loan to value ratio requirement will be 60% as an artificially low capitalization rate may result in a significantly higher market value for commercial real estate property.

The proposed rules would also require that the loan documentation contain certain specific covenants designed to enable the originator to monitor and manage the credit risk over the life of the loan (which the Agencies believe to reflect current industry practice and impose minimal compliance burdens). One such covenant would require providing the borrower’s financial information to the originator (or subsequent holder) and the servicer, including information on the property’s existing, maturing, and new leasing, or rent-roll, activity. Other prescribed covenants would restrict the ability of the borrower to constitute additional liens on the collateralized commercial real estate property as well as maintain and protect the originator’s (or subsequent holder’s) lien on that property. These covenants would be required not only of the borrower but also of other persons who may provide collateral for the qualifying commercial real estate loan.

C. Qualifying Automobile Loans

The Agencies appear to have decided that the QRM standards should be the starting point for the automobile loan underwriting standards despite the obvious differences between the two products. A qualifying automobile loan may cover either a new or used vehicle. These proposed standards deal with (a) the borrower’s ability to repay the loan, (b) loan terms, (c) the borrower’s credit history, and (d) a loan to value ratio requirement.

Since repayment of an automobile loan is reliant on a borrower’s monthly total debt obligations in relation to monthly income, the proposed rules would impose a borrower monthly debt to income ratio of less than or equal to 36% for a qualifying automobile loan. (This is consistent with the proposed debt to income ratio requirement for QRMs discussed above.) The NPR would also require the use of uniform methods for determining an automobile loan borrower’s income and debts to standardize the various income history requirements and types of information used by originators to underwrite automobile loans.

Fixed payment terms will also be required for qualifying automobile loans. The proposed rules would require a fixed interest rate, and calculation of monthly payments using straight-line amortization, for the term of the loan not to exceed five years, with the first payment due within 45 days following the closing date, and prohibit deferment of principal or interest.
addition, if the loan is for a new vehicle, the loan must have a maturity date that does not exceed five years from the closing date, and if the loan is for a used vehicle, must provide that the term of the loan, plus the difference between the current model year and the vehicle’s model year, cannot exceed five years. Also, the transaction documents must require physical possession by the originator or subsequent holder (or any of their agents) of the vehicle title until full repayment of the loan and satisfaction of all loan obligations.

The proposed qualifying automobile loan underwriting standards, consistent with the requirements for QRMs, will also require an originator to verify and document, within 30 days following the origination date, that the borrower (a) is not currently 30 days or more past due, in whole or in part, on any debt obligation and (b) has not been 60 days or more past due, in whole or in part, on any debt obligation within the past 24 months. Moreover, the originator must verify and document that, within the previous 36 months, the borrower was not a debtor in any bankruptcy proceeding, subject to judgment (federal or state) for collection of unpaid debt or foreclosure, repossession deed in lieu of foreclosure or short sale, and has not had any personal property repossessed. However, the proposed standards (consistent with the requirements for QRMs) provide a safe harbor from these verification and documentation requirements if, no more than 90 days before the closing of the automobile loan, the originator (a) obtained a credit report on the borrower from at least two national consumer reporting agencies that compile data on a nationwide basis and (b) determined, based on such credit reports, that the borrower met the credit history requirements discussed above. This safe harbor would be unavailable should the originator subsequently obtain a credit report to the contrary before the automobile loan closing.

Due to the rapid depreciation of automobiles, the proposed underwriting standards would require the originator to document that, at the time of closing, the borrower tendered a minimum downpayment sourced from its own funds and/or any trade-in allowance sufficient to pay (a) the full cost of vehicle title, tax, registration fees and any dealer-imposed fees, and (b) 20% of the automobile’s purchase price.

D. Qualifying Commercial Loans

Qualifying commercial loans are defined as any secured or unsecured loan that meets the underwriting standards set out below to a company or an individual for business purposes, other than a loan to purchase or refinance a one-to-four family residential property, a loan for the purpose of financing agricultural production, or a loan for which the primary source (that is, 50% or more) of repayment is expected to be derived from rents collected from persons or entities that are not affiliates of the borrower.

The underwriting standards for a qualifying commercial real estate loan focus on measures that are consistent with, but more prudent and conservative than, industry standards for evaluating the financial condition and repayment capacity of a borrower.

Ability to repay

The underwriting requirements of a qualifying commercial loan are as follows:

1. In the borrower’s two most recently completed fiscal years had, and the two-year period after the closing of the commercial loan the borrower is expected to have: (a) a total liabilities ratio of 50% or less, (b) a leverage ratio of 3.0 or less, and (c) a debt service coverage (DSC) ratio of 1.5 or greater.

2. The loan payments must be determined based on the straight-line amortization of principal and interest that fully amortize the debt over a term that does not exceed five years from the closing date for the loan.

3. Loan Payments must be no less frequent than quarterly over a term that does not exceed five years.
4. The loan documentation for the commercial loan must include, with respect to any collateral pledged to secure the loan, covenants that require the borrower to: (a) pay all applicable taxes, fees, charges and claims where nonpayment could give rise to a lien against the collateral, (b) take any action necessary to perfect or defend the security interest (or priority of the security interest) of the originator (or any subsequent holder of the loan) in the collateral against claims adverse to the lender’s interest, (c) maintain insurance that protects against loss on the collateral at least up to the amount of the loan, and that names the originator (or any subsequent holder of the loan) as an additional insured or loss payee (d) permit the originator or any subsequent holder of the loan, and the servicer of the loan, to inspect the collateral and the books and records of the borrower, and (e) maintain the physical condition of any collateral for the loan.

5. The loan documentation for the commercial loan must also include covenants that require the borrower to: (a) provide to the originator (or any subsequent holder) and the servicer financial information and supporting schedules on an ongoing basis, but not less frequently than quarterly, and (b) prohibit the borrower from retaining or entering into a debt arrangement that permits payments-in-kind, and place limitations on the transfer of any of the borrower’s assets, on the borrower’s ability to create other security interests with respect to any of its assets, and on any change to the name, location, or organizational structure of the borrower (or any other party that pledges collateral for the loan).

E. Buy Back Requirements

A sponsor that has relied on an exemption from the credit risk retention requirement discussed in this Section V will not lose such exemption even if, after the closing of the securitization transaction, it is determined that one or more of the loans in the securitized asset pool do not meet the applicable underwriting standards, provided that:

(i) the depositor has complied with the certification requirements regarding the effectiveness of its internal supervisory controls for verifying that the securitized assets meet the applicable “qualifying” underwriting standards;

(ii) the sponsor repurchases the non-qualifying loan(s) from the issuing entity at a price at least equal to the remaining principal balance and accrued interest on the loan(s) no later than 90 days after determination of the non-qualifying nature of such loan(s); and

(iii) the sponsor notifies to the holders of the ABS of the non-qualifying loan(s) that are required to be repurchased by the sponsor, including the principal amount of such repurchased non-qualifying loan(s) and the cause of such repurchase.
VI. Exemptions For Certain Types Of Transactions

A. General Exemptions

Under the NPR, certain types of securitizations and ABS are excluded from the risk retention requirements. Exempted transactions are as follows:

1. A securitization transaction collateralized solely by residential, multifamily, or health care facility mortgage loans insured or guaranteed as to interest and principal by the U.S. or an agency of the U.S.

2. A securitization transaction that involves the issuance of ABS that is insured or guaranteed by the U.S. or an agency of the U.S. and collateralized solely by residential, multifamily, or health care facility mortgage loans.

3. A securitization transaction collateralized solely by loans or other assets insured, guaranteed or purchased by Farm Credit Administration, including the Federal Agricultural Mortgage Corporation.

4. Any ABS issued or guaranteed by any State, or public subdivision or public instrumentality thereof, that is exempt from the registration requirements of the Securities Act pursuant to Section 3(a)(2) thereof.

5. Any ABS that meets the definition of qualified scholarship funding bond under the Internal Revenue Code of 1986, as amended.

6. Any resecuritization of assets (i) where credit risk was retained or (ii) listed in (1) through (5) above and that involved the issuance of only a single class of ABS interest that provides for the pass-through of all the principal and interest payments received.

7. Any securitization transaction if the ABS are (i) collateralized solely by obligations of the U.S. or any agency of the U.S. (ii) collateralized solely by assets that are fully insured or guaranteed as to principal and interest by the U.S. or any agency of the U.S. or (iii) the securities of which are guaranteed as to the timely payment of principal and interest by the U.S. or an agency of the U.S.

B. Safe harbor for certain foreign-related transactions

In order for a foreign-related transaction to be exempt, it must meet all of the following criteria:

1. The securitization is exempt from the registration requirements of the Securities Act.

2. No more than 10% of the U.S. dollar value (or its foreign currency equivalent) of the transaction of all classes of ABS is sold to U.S. persons (which is defined substantially the same as in Regulation S under the Securities Act).

3. Neither the sponsor nor the issuer is (i) a U.S. entity (ie., chartered, incorporated or organized in a U.S. jurisdiction), (ii) a U.S. entity's unincorporated branch or office located within or outside the U.S., nor (iii) a non-U.S. entity's unincorporated branch or office located in the US.

4. If the sponsor or issuer is a non-U.S. entity, no more than 25% of the underlying assets were acquired by the sponsor or issuing entity from (i) a consolidated affiliate of the sponsor or issuing entity that is a U.S. entity or (ii) an unincorporated branch or office of the sponsor or issuing entity which is located within the U.S.
Anti-Evasion Provisions: The exemption provided to foreign-related transactions are not available if the transaction is part of a plan or scheme to evade the risk retention requirements.

C. Additional Exemptions

The Federal agencies may write additional rules to include additional securitization exemptions.
## Risk Retention Initiatives Table
Risk Retention Initiatives

Summary and disclosure requirements under the proposed U.S. risk retention regime

Summary of Risk Retention Options and Related Disclosure Requirements

The tables below describe (1) the basic risk retention options provided under the NPR and applicable to all types of transactions and (2) additional risk retention options that apply to specific transaction types or under specific circumstances. The NPR also proposes, for any risk retention option, that the sponsor be required to provide certain disclosures to potential investors at a reasonable time prior to sale, and, upon request, to the SEC and the sponsor's appropriate Federal banking agency (if any). The most significant of these proposed disclosure requirements also are summarized for each option in the table below.

**Table 1: Basic Risk Retention Options**

<table>
<thead>
<tr>
<th>Option</th>
<th>Description of provision under Notice of Proposed Rulemaking (NPR)</th>
<th>Required Disclosure</th>
</tr>
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</table>
| Vertical Slice Option       | **Sponsor would satisfy its risk retention requirement by holding at least a **5%** **interest in each class of ABS interests**19 in the issuing entity20 issued as part of the securitization transaction.21 The aforementioned interest in each class of ABS interests must be retained in each class of ABS interest measured in each case by par value (if any), fair value, and number of shares or units. | - A separate statement of the percentage and dollar amount of each class of ABS interests that the sponsor, at closing, (1) actually retains and (2) is required, under the NPR, to retain; and  
- The material assumptions and methodologies the sponsor used to determine the aggregate dollar amount of ABS interest issued by the issuing entity (including estimated cash flows and discount rate). |
| Horizontal Slice Option     | **Eligible Horizontal Residual Interest.** The sponsor would satisfy its risk retention requirement by holding an eligible horizontal residual interest in the issuer that provides the sponsor with first-loss exposure to all ABS interest equal to at least 5% of the par value of all ABS interests in the issuing entity issued as part of the securitization. An eligible horizontal residual interest:  
  - is an ABS interest;  
  - takes a first-loss position; and  
  - has the most subordinated claim to payments of principal and interest.  
**Horizontal Cash Reserve Account.** As an alternative to retaining an eligible horizontal residual interest, the sponsor may satisfy the horizontal risk retention option by funding a horizontal cash reserve account in an | - A separate statement of the percentage and dollar amount of the eligible horizontal residual interest that the sponsor, at closing, (1) actually retains and (2) is required, under the NPR, to retain; and  
- A description of the material terms of the eligible horizontal residual interest; and  
- The material assumptions and methodologies the sponsor used to determine the aggregate dollar amount of ABS interests issued by the issuing entity (including estimated cash flows and discount rate).  

The foregoing disclosure requirements would apply whether the sponsor retains an eligible horizontal residual interest or elects instead to establish and fund a horizontal cash reserve account. |

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19 **ABS interest** is defined in the NPR to include "any type of interest or obligation issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest or residual interest, payments on which are primarily dependent on the cash flows of the collateral owned or held by the issuing entity." The definition *excludes*, however, "common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests that (i) are issued primarily to evidence ownership of the issuing entity; and (ii) [t]he payments, if any, on which are not primarily dependent on the cash flows of the collateral held by the issuing entity."

20 Under the NPR, **issuing entity** means, "with respect to a securitization transaction, the trust or other entity: (1) [t]hat is created at the direction of the sponsor; (2) [t]hat owns or holds the pool of assets to be securitized; and (3) [i]n whose name the asset-backed securities are issued."

21 The NPR defines **Securitization transaction** as "a transaction involving the offer and sale of asset-backed securities by an issuing entity."
The horizontal cash reserve account must be available to fully satisfy payments on ABS interests when the issuing entity has insufficient funds to do so, meaning that the account would take the equivalent of a first-loss position in the same manner as the residual interest. Certain additional conditions, including investment restrictions and limitations on the circumstances in which amounts can be withdrawn, would apply to horizontal cash reserve accounts.

### L-Shaped Option

**Vertical and Horizontal Components.** The L-Shaped option combines the Vertical Slice and Horizontal Slice options discussed above. Under this option, the sponsor must retain both of the following:

- **Vertical Component.** At least 2.5% of each class of ABS interests in the issuing entity.
- **Horizontal Component.** An eligible horizontal residual interest equal to at least 2.564% of the par value of all ABS interests in the issuing entity, other than those interests required to be retained as part of the vertical component.

**Horizontal Cash Reserve Account in Lieu of Horizontal Component.** As an alternative to the Horizontal Component, a sponsor using the L-Shaped may establish and fund a horizontal cash reserve account in an amount equal to at least 2.564% of the par value of all of the ABS interests issued as part of the securitization transaction.

### Representative Sample Option

Sponsor may satisfy its risk retention requirement by retaining a randomly selected representative sample of assets:

- that is equivalent, in all material respects, to the securitized assets; and
- having a total unpaid principal balance at least equal to 5% of the designated pool (based on the unpaid principal balance of all assets initially identified for inclusion in the pool).

**Designated Pool.** Sponsor must create a designated pool of at least 1,000 separate assets for securitization. Further, the representative sample must equal 5/95ths (5.264%) of the aggregate unpaid principal balance of the assets that are securitized in the securitization. The representative sample and the securitized assets must come from the same designated pool.

**Statistical Checks.** The representative sample must be statistically tested to confirm that, for each material characteristic of the assets, the mean of any quantitative characteristic, and the portion of any characteristic that is categorical in nature, are within a 95% two-tailed confidence interval of the mean or proportion, respectively, of the same characteristic of all the assets in the designated pool.
### Table 2: Transaction-Specific Options and Additional Requirements

<table>
<thead>
<tr>
<th>Provision</th>
<th>Description of provision under Notice of Proposed Rulemaking (NPR)</th>
<th>Required Disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revolving Asset Master Trusts (Seller's Interest)</strong></td>
<td>Solely with respect to securitizations involving lines of credit, a sponsor of a revolving asset master trust could satisfy the risk retention requirement by holding a seller's interest in an amount equal to at least 5% of the unpaid principal balance of all assets held by the issuing entity.</td>
<td>− A separate statement of the percentage and dollar amount of the seller's interest that the sponsor, at closing, (1) actually retains and (2) is required, under the NPR, to retain; − A description of the material terms of the seller's interest; and − The material assumptions and methodology used in determining the aggregate dollar amount of ABS interest issued by the issuer (including estimated cash flows and discount rate).</td>
</tr>
<tr>
<td><strong>Asset Backed Commercial Paper (ABCP) Conduits</strong></td>
<td>Sponsor's risk retention obligations in relation to an eligible ABCP conduit (one that meets the requirements specified in the NPR) will be satisfied if each originator-seller retains, in each intermediate SPV established by or on behalf of that originator-seller, an eligible horizontal residual interest equal to at least 5% of the principal balance of all of the assets issued by the intermediate SPV. The eligible horizontal residual interest retained by the originator-seller will be subject to the same conditions and requirements applicable to such interest under the horizontal risk retention option. Additional conditions apply, including that the sponsor provide 100% liquidity coverage to all the ABCP issued by the issuing entity.</td>
<td>− The name and form of organization of each originator-seller that did or will retain an interest in the securitization (including the form, percentage and dollar amount, and nature of such interest); and − The name and form of organization of each regulated liquidity provider supporting the eligible ABCP conduit (including a description of the form, amount, and nature of such liquidity coverage).</td>
</tr>
<tr>
<td><strong>B-Piece Buyer of Commercial Mortgage Backed Securities (CMBS)</strong></td>
<td>Sponsor of CMBS, where at least 95% of the total unpaid principal balance of the securitized assets in the securitization are commercial real estate loans, may satisfy its risk retention requirements if a third-party purchaser (the B-Piece Buyer) acquires an eligible horizontal residual interest, in accordance with these six conditions: − The B-Piece Buyer must retain an eligible horizontal residual interest in the securitization in the same form, amount, and manner as required of the sponsor under the horizontal risk retention option; − The B-Piece Buyer must pay for the first-loss subordinated interest in cash at the securitization's closing without financing being provided from any party to the securitization aside from an investor; − The B-Piece Buyer must review the credit risk of each asset in the pool prior to the sale of the ABS (including underwriting standards, collateral, and expected cash flows of each commercial loan in the pool); − The B-Piece Buyer may neither (i) be an affiliate of any other party to the securitization, nor (ii) have any control rights in the securitization, except that the B-Piece Buyer may be affiliated with one or more originators originating less than 10% of the unpaid principal balance of the securitized assets and may act as, or be an affiliate of, a servicer for any of the assets if the underlying securitization transaction</td>
<td>− The name and form of organization of the B-Piece Buyer and a description of its experience in CMBS investing; − Any other information regarding the B-Piece Buyer or the B-Piece Buyer's retention of the eligible horizontal residual interest material to investors; − The purchase price paid for, and material terms of, such interest; − A separate statement of the percentage and dollar amount of the eligible horizontal residual interest that, at closing, (1) the sponsor would have been required to retain if the sponsor had retained an interest under the Horizontal Slice option and (2) the B-Piece Buyer actually retains; − The material assumptions and methodology used in determining the aggregate dollar amount of ABS interest issued by the issuer (including estimated cash flows and discount rate); and − The representations and warranties made as to the securitized assets, a schedule of such assets that are determined not to comply with such representations and warranties, and the factors that were used to determine that any non-complying assets should be included.</td>
</tr>
</tbody>
</table>
documents provide for the appointment of an operating advisor;

- The sponsor must make the required disclosures to prospective investors (see column opposite); and

- Any B-Piece Buyer acquiring an eligible horizontal residual interest must comply with the hedging, transfer, and other restrictions applicable to such interest under the NPR if the B-Piece Buyer was a sponsor who had acquired the interest under the horizontal risk retention option.

<table>
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<tr>
<th>Mortgage Backed Securities Guaranteed by Fannie Mae or Freddie Mac</th>
<th>A guaranty provided by Freddie Mac or Fannie Mae, while operating under the conservatorship of the Federal Housing Finance Agency, will satisfy the risk retention requirement with respect to any MBS issued by Freddie Mac or Fannie Mae and so guaranteed.</th>
</tr>
</thead>
</table>
| Additional Requirements: Premium Capture Cash Reserve Account | Sponsor retaining credit risk under the Vertical Slice, Horizontal Slice, L-Shaped, or Revolving Asset Master Trust options must establish and fund at closing a **premium capture cash reserve account** equal to any positive difference between:

- the gross proceeds received by the issuing entity from the sale of ABS interests to persons other than the sponsor (net of closing costs paid by a sponsor or the issuer to unaffiliated parties); and

- **95%** of the par value of all ABS interests issued as part of the securitization.

Sponsors retaining credit risk under the representative sample, ABCP, or B-Piece Buyer of CMBS options must establish and cash-fund at closing a premium capture reserve account equal to any positive difference between:

- the gross proceeds received by the issuing entity from the sale of ABS interests to persons other than the sponsor (net of closing costs paid by a sponsor or the issuer to unaffiliated parties); and

- **100%** of the par value of all ABS interests issued as part of the securitization.

- The manner in which the sponsor has met the credit risk retention requirement of the NPR.

- The dollar amount required, under the NPR, to be placed in the premium capture cash reserve account and any other amounts the sponsor has deposited or will deposit in the account in connection with the securitization;

- The material assumptions and methodology used in determining (i) the fair value of any ABS interests in the issuing entity that does not have a par value, and that is subject to the anti-evasion provisions of the NPR, and (ii) the aggregate dollar amount of ABS interest issued by the issuer (including estimated cash flows and discount rate).
Annex

Section 15G(c) of the Exchange Act

(c) STANDARDS FOR REGULATIONS—

(1) STANDARDS — The regulations prescribed under subsection (b) shall—

(A) prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset;

(B) require a securitizer to retain—

(i) not less than 5% of the credit risk for any asset—

(1) that is not a qualified residential mortgage that is transferred, sold, or conveyed through the issuance of an ABS by the securitizer; or

(2) that is a qualified residential mortgage that is transferred, sold, or conveyed through the issuance of an ABS by the securitizer, if one or more of the assets that collateralize the ABS are not qualified residential mortgages; or

(ii) less than 5% of the credit risk for an asset that is not a qualified residential mortgage that is transferred, sold, or conveyed through the issuance of an ABS by the securitizer, if the originator of the asset meets the underwriting standards prescribed under paragraph (2)(B);

(C) specify—

(i) the permissible forms of risk retention for purposes of this Section;

(ii) the minimum duration of the risk retention required under this Section; and

(iii) that a securitizer is not required to retain any part of the credit risk for an asset that is transferred, sold or conveyed through the issuance of an ABS by the securitizer, if all of the assets that collateralize the ABS are qualified residential mortgages;

(D) apply, regardless of whether the securitizer is an insured depository institution;

(E) with respect to a commercial mortgage, specify the permissible types, forms, and amounts of risk retention that would meet the requirements of subparagraph (B), which in the determination of the Federal banking agencies and the SEC may include—

(i) retention of a specified amount or percentage of the total credit risk of the asset;

(ii) retention of the first-loss position by third-party purchaser that specifically negotiates for the purchase of such first loss position, holds adequate financial resources to back losses, provides due diligence on all individual assets in the pool before the issuance of the ABS, and meets the same standards for risk retention as the Federal banking agencies and the SEC require of the securitizer;

(iii) a determination by the Federal banking agencies and the SEC that the underwriting standards and controls for the asset are adequate; and
(iv) provision of adequate representations and warranties and related enforcement mechanisms; and

(F) establish appropriate standards for retention of an economic interest with respect to collateralized debt obligations, securities collateralized by collateralized debt obligations, and similar instruments collateralized by other ABS; and

(G) provide for—

(i) a total or partial exemption of any securitization, as may be appropriate in the public interest and for the protection of investors;

(ii) a total or partial exemption for the securitization of an asset issued or guaranteed by the United States, or an agency of the United States, as the Federal banking agencies and the SEC jointly determine appropriate in the public interest and for the protection of investors, except that, for purposes of this clause, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation are not agencies of the United States;

(iii) a total or partial exemption for any ABS that is a security issued or guaranteed by any State of the United States, or by any political subdivision of a State or territory, or by any public instrumentality of a State or territory that is exempt from the registration requirements of the Securities Act of 1933 by reason of Section 3(a)(2) of that Act (15 U.S.C. 77c(a)(2)), or a security defined as a qualified scholarship funding bond in Section 150(d)(2) of the Internal Revenue Code of 1986, as may be appropriate in the public interest and for the protection of investors; and

(iv) the allocation of risk retention obligations between a securitizer and an originator in the case of a securitizer that purchases assets from an originator, as the Federal banking agencies and the SEC jointly determine appropriate.

(2) ASSET CLASSES—

(A) ASSET CLASSES—The regulations prescribed under subsection (b) shall establish 6 asset classes with separate rules for securitizers of different classes of assets, including residential mortgages, commercial mortgages, commercial loans, auto loans, and any other class of assets that the Federal banking agencies and the Commission deem appropriate.

(B) CONTENTS—For each asset class established under subparagraph (A), the regulations prescribed under subsection (b) shall include underwriting standards established by the Federal banking agencies that specify the terms, conditions, and characteristics of a loan within the asset class that indicate a low credit risk with respect to the loan.
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