

Scott A. Sinder
202.429.6289
ssinder@steptoe.com

1330 Connecticut Avenue, NW
Washington, DC 20036-1795
Tel 202.429.3000
Fax 202.429.3902
steptoe.com

March 31, 2011

TO: CRE Finance Council

FROM: Scott A. Sinder
Rhonda M. Bolton

RE: Overview of Proposed Dodd-Frank Risk Retention Regulation

On March 29, 2011, the proposed regulations to govern credit risk retention by securitizers of asset-backed securities, jointly developed by federal banking regulators and the Securities and Exchange Commission as required by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, were issued.¹ For commercial mortgage-backed securities (“CMBS”), these rules will go into effect in April of 2013; comments on the proposed rules are due on June 10, 2011. This memorandum provides an overview of the regulations to the extent they affect CMBS.

Overall, the proposed rule contains some positive aspects for the CRE finance space (for example, a B-piece buyer is allowed to retain risk under certain conditions, and there are options in terms of permissible forms for holding the retained risk). At the same time, certain aspects of the rule also likely present cause for concern, including potential restrictions on interest-only tranches, and a requirement for an independent operating advisor to oversee servicing when a B-piece buyer retains the mandated risk and is involved in servicing. CREFC will need significant member input to assure that the association responds to the proposed rule in a way that promotes a viable retention regime for commercial mortgages and CMBS.

Overview and Summary

The Risk Retention Notice of Proposed Rulemaking (“NPRM”) generally establishes a “base” risk retention framework for ABS, including a bright-line 5% minimum credit risk retention

¹ Proposed Rule, Credit Risk Retention, Federal Deposit Insurance Corporation et al., FDIC Docket No. 2011-____ (rel. Mar. 29, 2011) (hereafter, “Risk Retention NPRM”), available at <http://www.fdic.gov/news/board/29Marchno2nonSEC.pdf>. More than one of the relevant agencies may publish a version of the NPRM; it is not yet clear whether these versions will be identical. The page references in this memorandum are to the version released by the FDIC on March 29, 2011.

requirement, with the sponsor(s) having the ability to choose between a number of options for how to hold the retained interest. There is no time limit on the retention period. The retained interest must be held, and generally cannot be transferred, until all ABS interests are paid in full. Several new disclosure requirements would also be imposed.

Significantly for commercial mortgage loan pools, retention by a B-piece buyer is among the options for retention, subject to some specified conditions. Most significantly, a requirement that an independent operating advisor be appointed to oversee servicing if a B-piece buyer is holding the retained interest and also is acting the special servicer would be imposed if the retention requirement is to be satisfied through the B-piece buyer.

Under the proposed rule, restrictions would be imposed on hedging the credit risk associated with the retained interest, but interest rate hedges and investment in ABS-indices are both expressly permitted. In addition, restrictions on the ability of sponsors to monetize excess spread on underlying assets at the inception of the securitization transaction, such as through sale of premium or interest-only (“IO”) tranches also would be imposed; this restriction appears to be an effort by regulators to discourage use of IO strips.

In addition to the base retention framework, the Risk Retention NPRM also establishes a set of “exempt” transactions, by asset class, which would be subject to a 0% risk retention requirement. Much attention in this regard has been devoted to the regulators’ development of a “qualified residential mortgage” (“QRM”) standard for the residential space, but an analogous concept also would be established in the commercial space, termed under the NPRM as “qualifying” CRE loan pools.

There are approximately 33 separate requirements – in the form of prescriptive underwriting criteria – that must be met in order to be a qualifying CRE loan exempt from the retention requirements. Such prescriptive standards reflect the regulators’ stated intention that few loan pools will be able to satisfy the criteria, the result being that most securitizations will be subject to the 5% risk retention requirement. We note that the underwriting criteria in the proposal do not directly track those developed by CREFC, although there clearly is a fairly extensive amount of conceptual overlap.

Notable among the many criteria that must be satisfied are finite numeric ones such as having a debt service coverage (“DSC”) ratio of 1.5-1.7 or better depending on the property type, and having a combined loan-to-value (“CLTV”) ratio less than or equal to 65%, (or 60% in some cases). Loan payments would have to be amortized over 20 years, with an initial loan term of no less than 10 years. And borrower covenants would preclude mezzanine financing. While a number of the qualifying loan criteria are probably ones already employed in the commercial space, the proposal should be examined closely to determine whether, viewed in totality, the exemption criteria are so conservative that the exemption will prove useless, or whether they are appropriately calibrated.

The Risk Retention NPRM raises a number of issues that CREFC will need to consider, beyond the broad question of whether the base risk retention mandate is acceptable. Important specific matters that should be considered – and addressed in comments – include, for example, the appropriate duration of the retention obligation; the impact of the independent operating advisor requirement for B-piece buyer/special servicers seeking to retain the mandated interest; the potential impact of limits on the ability to immediately monetize excess spread, whether this would preclude sales of IO strips, and how this would impact the economics of CMBS transactions; whether the hedging restrictions are workable; and, as noted, whether the parameters for qualifying as an exempt CRE loan pool are too restrictive or are appropriate. Moreover, consideration should be given to questions of whether

additional frameworks, such as use of industry-standard representations and warranties, should be proposed as an alternative form of risk retention, keeping in mind that – at this point – any alternative proposal that is advanced should match the relatively detailed nature of the underwriting-based exemption regulators have already proposed in the NPRM.

Comments on the Risk Retention NPRM are due June 10, 2011. The proposed rules are discussed in more detail below along with a list of initial questions that should be considered for each relevant component of the rules. In addition, the questions posed by the regulators in the NPRM are included in an appendix that also is arranged by pertinent subject area.²

Analysis

I. The “Base” Risk Retention Requirement

A. Scope

The risk retention rules will apply to the issuance of “asset-backed securities,” as that term is defined in Dodd-Frank.³ The rules will apply to securitization transactions regardless of whether the transactions are registered with the SEC.⁴ The rules will also apply to securitizations by non-bank entities as well as insured depository institutions.⁵ Finally, the rules will apply to securitizations by Fannie Mae and Freddie Mac, although the NPRM proposes that so long as these entities are operating under federal receivership or conservatorship with capital support from the government, the guarantees provided by Fannie Mae and Freddie Mac will be deemed to satisfy the risk retention requirement, since regulators view the guarantees as a form of 100% risk retention.⁶

B. Parties to Whom The Risk Retention Obligation Applies

The risk retention obligation will be imposed on the “sponsor” of the securitization, defined as “a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity,”⁷ consistent with the definition of “sponsor” in SEC Regulation AB.

² The question numbers referenced in the appendix correspond to those in the NPRM.

³ Dodd-Frank generally defines “asset-backed security” to mean a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, lease, mortgage, or other secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset. *See* Risk Retention NPRM at 26 (citing Dodd-Frank Section 941(a)). The NPRM notes that the rules would not apply to synthetic securitizations. Risk Retention NPRM at 26, n.32.

⁴ *See* Risk Retention NPRM at 28.

⁵ *Id.* at 35.

⁶ *See* 83-86.

⁷ *Id.* at 245 (Definitions in Proposed Regulation § __.2). The risk retention rules generally would not be applied to the “depositor” of the ABS, a term the NPRM interprets to be synonymous with “issuer” of the ABS. *See* Risk Retention NPRM at 31.

Where two or more entities each meet the definition of “sponsor” for a single securitization, the proposed regulation states that it shall be the responsibility of each to ensure that “at least one” of the sponsors retains risk in accordance with the rule.⁸ While this language seems to contemplate sharing the risk retention obligation among multiple sponsors, there is language in the accompanying narrative and inquiries that seem inconsistent with this conclusion.⁹ Accordingly, clarification should be sought on the issue of whether sponsors could share the risk retention obligation.

It is clear, however, that a sponsor is permitted to share the risk retention obligation with an originator, which would reduce the sponsor’s obligation by the amount allocated to the originator. An originator is defined as a person who (1) through an extension of credit or otherwise, creates an asset that collateralizes an asset-backed security; and (2) sells the asset directly or indirectly to a securitizer.¹⁰ The proposal notes that this definition means only the original creditor, and not a subsequent purchaser or transferee, is an “originator” for these purposes.¹¹ There are conditions that must be met for sponsors to allocate part of the risk retention obligation to an originator.¹² Most notably, the originator must have contributed at least 20% of the assets to the underlying pool. And the originator would be required to hold a percentage of the retention interest equal to at least 20%, but could not exceed the percentage of securitized assets it originated. The originator would have to hold its allocated share in the same manner as the sponsor (e.g., vertical slice), and subject to the same restrictions as are applicable to the sponsor (e.g., hedging). This mechanism is limited to situations where the sponsor has elected to hold its retained interest in either the vertical slice or horizontal options, and, the rule notes, is optional, not mandatory.

C. Duration

Although the proposed rule does not explicitly state that the risk retention obligation has no expiration, this fact is implicit in the structure of the rule, its prohibitions on the sale or transfer of the retained interest, and its many specifications for the retained interest that apply until all ABS interests in the issuing entity have been fully paid or the issuing entity has been dissolved.¹³ The question of whether a shorter duration should be proposed is one that should be considered for comments.

D. Percentage and Permissible Forms of Risk Retention

The proposal generally requires that a sponsor retain an economic interest equal to at least 5% of the aggregate credit risk of the assets collateralizing an issuance of ABS.¹⁴ The retained risk may be

⁸ *Id.* at 247 (Proposed Regulation § .3(b)).

⁹ *See id.* at 30 (“where two or more entities each meet the definition of sponsor for a single securitization transaction, the proposed rules would require that one of the sponsors retain a portion of the credit risk”).

¹⁰ *Id.* at 242 (Definitions in Proposed Regulation § .2).

¹¹ *See id.* at 32.

¹² *See id.* at 270-72 (Proposed Regulation § .13), and discussion at 95-98.

¹³ *See, e.g., id.* at 47 (requirements for cash reserve account held in lieu of an eligible horizontal residual interest).

¹⁴ *See id.* at 34-35.

held in any of the forms defined by the rule as permissible, which are, most relevantly for CMBS:¹⁵ vertical slice, horizontal first-loss, L-shaped, or risk retained by a B-piece buyer.

There are conditions and disclosure requirements associated with each permissible form, as follows:

1. *Vertical Slice*: A sponsor using this approach must retain at least 5% of each class of ABS interests issued in the securitization transaction regardless of the nature of the class of ABS interests (e.g., senior or subordinated) and regardless of whether the class of interests has a par value, was issued in certificated form, or was sold to unaffiliated investors.¹⁶ The proposal advises that it does not specify a method of measuring the amount of each class, because the amount retained, regardless of method of measurement, should equal at least five percent of the par value (if any), fair value, and number of shares or units of each class.¹⁷ However, the sponsor is required to provide to investors (and upon request, to regulators), a disclosure containing:
 - the amount (expressed as a percentage and a dollar amount) of each class of ABS interests in the issuing entity that the sponsor will retain (or did retain) at closing;
 - the amount (expressed as a percentage and dollar amount) that the sponsor is required to retain under the rules; and,
 - the material assumptions and methodologies used to determine the aggregate dollar amount of ABS interests issued by the issuing entity, including those pertaining to any estimated cash flows and the discount rate used.¹⁸
2. “*Eligible Horizontal Residual Interest*”: an “eligible” horizontal interest requires the sponsor to retain a first-loss exposure equal to at least 5% of the par value of all ABS interests issued by the issuing entity as part of the securitization transaction.¹⁹ In lieu of this requirement, the sponsor may also establish and fund, in cash, a reserve account at closing in an amount equal to at least 5% of the par value of all the ABS interests issued as part of the transaction, subject to certain restrictions including having the account held by a trustee or similar entity for the benefit of the issuing entity.²⁰ There are several

¹⁵ Other permissible forms not relevant to the CMBS space include holding a representative sample or a “seller’s interest”.

¹⁶ *Id.* at 42.

¹⁷ *See id.*

¹⁸ *See id.* at 42-43.

¹⁹ *Id.* at 248 (Proposed Regulation § __.5)

²⁰ *See id.* at 46-47.

conditions designed to ensure that the horizontal interest (or cash reserve account in lieu thereof) is in a first-loss position, including, notably, a requirement that until all other ABS interests in the issuing entity are paid in full, the eligible horizontal interest cannot receive any unscheduled payments of principal made on a securitized asset, including pre-payments of principal and principal payments made on the underlying assets derived from proceeds from the sale of, or foreclosure on, the an underlying asset.²¹ Similar to the disclosure requirements under the vertical slice retention option, a sponsor using the horizontal option would be required to provide to investors (and upon request, to regulators), a disclosure containing:

- the amount (expressed as a percentage and a dollar amount) of the eligible horizontal residual interest that will be retained (or was retained) by the sponsor at closing;
- the amount (expressed as a percentage and dollar amount) of the eligible horizontal residual interest required to be retained under the rules;
- a description of the material terms of the eligible horizontal residual interest, such as when such interest is allocated losses or may receive payments; and,
- the material assumptions and methodologies used to determine the aggregate dollar amount of ABS interests issued by the issuing entity, including those pertaining to any estimated cash flows and the discount rate used.²²

3. *L-Shaped Risk Retention*: The L-shape involves holding an approximately equal combination of vertical risk retention and horizontal risk retention, specifically, holding 2.5% of each class issued as part of the securitization transaction (the vertical component); and holding an eligible horizontal residual interest in an amount equal to at least 2.564% of the par value of all ABS interests issued as part of the securitization transaction, other than those interests required to be retained as part of the vertical component (the horizontal component).²³ The sponsor would be required to hold 50% of its required risk retention in the form of a vertical component and 50% in a horizontal component. And since both

²¹ *See id.* at 45. Limitations on a cash reserve account held in lieu of a horizontal interest include the requirement that the account be used to satisfy payments on ABS interests when the issuer has insufficient funds from any source (including any premium capture cash reserve account discussed below) to satisfy an amount due on any ABS interest, and a prohibition on any other withdrawals except in very limited circumstances. *See id.* at 47.

²² *See id.* at 46. Similar disclosure requirements apply to a cash reserve account used in lieu of a horizontal interest. *See id.* at 48.

²³ *Id.* at 50. The proposal advises that the horizontal component for the L-shape has been calibrated at 2.564% to avoid double counting that portion of the horizontal interest that the sponsor is required to hold as part of the vertical component.

forms of retention are used, sponsors would be required to comply with the disclosure obligations applicable to both vertical slice and the horizontal option.

4. *Retention by B-Piece Buyer:* for CRE loans only, the proposal would permit the sponsor to satisfy its retention obligation by having a third party purchaser acquire an eligible horizontal residual interest in the issuing entity in the same form, amount, and manner as the sponsor would have been required to retain, provided that several additional conditions are met. These conditions are discussed below in the section dealing with CMBS-specific provisions of the proposed rule. It is important to note that for this form of retention, and any other that allows the sponsor to allocate its retention obligation to another party (e.g., allocation to originator), the rule would still hold the sponsor responsible for ensuring the third party's compliance with the risk retention framework.²⁴ Monitoring mechanisms would accordingly be necessary for the sponsor to ensure compliance.

E. Hedging and Transfer Restrictions

While hedging of the retained risk is generally prohibited, the rule does allow certain types of hedging activities, most notably, those that are not materially related to the credit risk of the particular ABS interests or exposures the sponsor is required to retain. Thus, hedging of market interest rate risk and foreign exchange risk are generally allowed.²⁵ And sponsors are also allowed to invest in ABS indices if (i) any class of ABS interests issued in connection with the securitization transaction and that are included in the index represents 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 under the rule 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 terms of transfer restrictions, the retained risk generally cannot be sold or transferred. There is an exception, however, for transfer to a “consolidated affiliate,” defined as an entity whose financial statements are consolidated with those of the sponsor.²⁶ There is also a prohibition on pledging the retained risk as collateral for any non-recourse obligation.²⁷

F. Premium Capture Cash Reserve Account

One very interesting element of the proposed rule is the requirement for a “premium capture cash reserve account” in situations where a sponsor structures a securitization to monetize excess spread on the underlying assets, which is typically done through the sale of IO tranches or premium bonds. The proposed rule advises that regulators view IO strips and the like as partly to blame for

²⁴ See *id.* at 34, n. 50.

²⁵ See *id.* at 272-74 (Proposed Regulation § 14).

²⁶ See *id.* at 100. Note that because transfer to consolidate affiliates is permitted, all hedging restrictions apply to consolidated affiliates.

²⁷ See *id.* at 103, 274.

creating “incentives to maximize securitization scale and complexity, and encourag[ing] aggressive underwriting.”²⁸ It appears that regulators seek to disincentivize sponsors from structuring transactions in this fashion by requiring the capture of any monetized excess spread that would be received at closing, and having it be held in the first-loss position (positioned even before a B-piece buyer’s retained interest), in addition to the 5% retained risk, until ABS interests in the issuing entity are paid in full or the issuing entity is dissolved.²⁹

The amount to be held in the account would be calculated by computing: the gross proceeds (net of closing costs paid by the sponsor(s) or issuing entity to unaffiliated parties) received by the issuing entity from the sale of ABS interests in the issuing entity to persons other than the retaining sponsor, minus 95% of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction (in the case of risk retained in the vertical, horizontal or L-shaped forms) (or 100% where the risk is retained by a B-piece buyer).

Several other conditions apply to premium capture cash reserve accounts, including a requirement that the account be held by a trustee, anti-evasion, and disclosure provisions.³⁰

Given the significant concerns about how this requirement would impact use of IO tranches, and whether it would negatively impact CMBS issuance, the existence and structure of premium capture cash reserve accounts is an issue that the industry should closely examine and comment on.

G. Disclosure Requirements

As mentioned, the proposed rule includes a number of new disclosure requirements. Rather than collect all the disclosure requirements into one section of the rule text, it should be noted that the disclosure requirements are scattered throughout the proposed rule, although from a substantive standpoint, they all primarily relate to explaining what risk was retained and by whom, and how the sponsor calculated the precise amount of its risk retention obligation.

H. Questions to Consider Regarding the Base Risk Retention Requirement

To recap, some of the significant issues and questions raised by the “Base” risk retention requirements, which CREFC’s members should examine, are:

- Whether the base risk retention regime, on the whole, is acceptable;
- Whether the risk retention obligation can be shared among multiple sponsors;
- The appropriate duration of the retention obligation and whether it should extend for the life of the transaction, as proposed;
- Whether the hedging restrictions are workable; and,

²⁸ *Id.* at 89.

²⁹ *See id.* at 266-70 (Proposed Regulation § __.12)

³⁰ *See id.* at 91-94.

- The potential impact of limits on the ability to immediately monetize excess spread, whether this would preclude IO strips, and how this would impact the economics of CMBS transactions.

II. CMBS-Specific Provisions

There are two notable provisions in the proposed rule that are specific to the CMBS space: the ability to have a third-party purchaser (i.e., B-piece buyer) retain the risk as part of the “base” risk retention regime; and a framework for CRE loan pools to be exempt from the risk retention requirements.

A. Retention By a Third Party Purchaser

In recognition of the fact that B-piece buyers have traditionally been part of CRE loan securitizations, Dodd-Frank allowed risk retention regulations to provide for retention of a first loss position by a 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, and meets the same standards for risk retention as are required of the securitizer.

The proposed rule would effectuate this by imposing six conditions in order for a third-party purchaser to retain risk under the rule. Preliminarily, it should be noted that third-party retention is only permitted for CMBS, and commercial real estate loans³¹ must constitute at least 95% of the unpaid principal balance of the assets being securitized.

The six conditions that must be met for a third party purchaser to retain the first are:

1. *Horizontal, First-Loss Position:* The third-party purchaser must retain an 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. It follows that the interest acquired by the third-party purchaser must be the most junior interest in the issuing entity, and must be subject to the same limits on payments as would apply if the eligible horizontal residual interest were held by the sponsor.
2. *Cash:* The third-party purchaser 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 (other than a person that is a party solely by reason of being an investor).

³¹ A “commercial real estate loan” is defined as a loan secured by a property with five or more single family units, or by nonfarm nonresidential 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. *See id.* at 75, n.89. Excluded from the definition are land development and construction loans (including 1- to 4-family residential or commercial construction loans), any other land loans, loans to a real estate investment trust (REIT), and unsecured loans to a developer.

3. *Asset Review*: The third-party purchaser must perform a review of the credit risk of each asset in the pool prior to the sale of the asset-backed securities, including, at a minimum, underwriting standards, collateral, and expected cash flows of each commercial loan in the pool.
4. *Operating Advisor if B-Piece Buyer Involved in Servicing*: The third-party purchaser would be prohibited from (i) being affiliated with any other party to the securitization transaction (other than investors); or (ii) having control rights in the securitization (including, but not limited to acting as servicer or special servicer) that are not collectively shared by all other investors in the securitization. The third-party purchaser could act as (or be affiliated with) the servicer or special servicer, however, if the underlying securitization transaction documents provide for the appointment of an independent operating advisor (Operating Advisor) with certain powers and responsibilities. Among the requirements pertaining to the Operating Advisor, the Operating Advisor would have to be consulted regarding “major” servicing decisions such as material modifications or waivers, foreclosures, and any acquisition of a property. The Operating Advisor would be tasked with reviewing and reporting on the servicer’s actions. And significantly, the Operating Advisor would have the authority to recommend that a servicer be replaced if it determines, “in its sole discretion exercised in good faith, that the servicer has failed to comply with any standard required of the servicer as provided in the applicable transaction documents and that such replacement would be in the best interest of the investors as a collective whole.” If such a recommendation is made, the servicer would be required to be replaced unless a majority of each class of certificate holders eligible to vote on the matter votes to retain the servicer.
5. *Sponsor Disclosures*: The sponsor would be required to provide a number of disclosures concerning the third-party purchaser and other information concerning the transaction. Some of the disclosure requirements are vague, such as the third party purchaser’s experience in investing in CMBS and “any other information regarding the third-party purchaser or the third-party purchaser’s retention of the eligible horizontal residual interest that is material to investors in light of the circumstances of the particular securitization transaction.” Information about the amount of risk to be retained by the third party, and how that amount was calculated must be provided. And the sponsor would also be required to provide potential investors with the representations and warranties concerning the securitized assets, a schedule of any assets that are determined not to comply 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 exceptions(s) were not material.³²

³² The NPRM notes CREFC’s development of industry standard representations and warranties and asks whether blacklines should be required against industry standards. *See id.* at 82.

6. *Hedging Restrictions*: Lastly, the third-party purchaser would be required to comply with the hedging, transfer and other restrictions applicable to such interest as if the third-party purchaser was a sponsor.³³

Although not enumerated among the six conditions, there is also a requirement obligating the sponsor to remain responsible for the third party purchaser's compliance with the six conditions. This means the sponsor would need to establish and maintain policies and procedures to monitor the third-party purchaser's compliance. The proposal further provides that if the sponsor determines that the third-party purchaser is out of compliance, the sponsor must "promptly notify the investors in the securitization transaction of such noncompliance."³⁴

There are a few important matters left unclear by the third-party purchaser provision. The proposal speaks in terms of risk retention by "a" third-party, thus it is unclear whether multiple B-piece buyers should share the risk retention obligation. The proposal also does not address whether, or how, the risk retention obligation could be shared by a sponsor and a third-party. Clarification should be sought as to both of these issues.

Finally, it is likely that significant attention will be drawn to the independent Operating Advisor requirement. The NPRM notes that this requirement is drawn from a similar one that was imposed as part of the Term-Asset Backed Securities Lending Facility ("TALF") program, to address concerns about potential conflicts-of-interest created by special servicer arrangements involving B-piece buyers. The parameters of the Operating Advisor requirement should be closely examined to assess their impact and whether they would make retention by B-piece buyers too much of an unattractive proposition.

B. "Exempt"/"Qualified" Loan Pools With 0% Retention Requirement

The Risk Retention NPRM establishes a category of "exempt" or "qualified" CRE loan pools, which seem to be conceptually analogous to QRM in the residential space. There are approximately 33 separate requirements – in the form of prescriptive underwriting criteria – that must be met in order to be a qualifying CRE loan exempt from the retention requirements, which reflects the regulators' stated intention that few loan pools will be able to satisfy the criteria, the result being that most securitizations will be subject to the 5% risk retention requirement. We note that the underwriting criteria in the proposal do not directly track those developed by CREFC, although there clearly is a fairly extensive amount of conceptual overlap.

Perhaps the best way to describe these criteria is to reproduce them from the text of the proposed regulation. The criteria are as follows:³⁵

³³ *Id.* at 260-65 (Proposed Regulation § __.10) (setting forth the six conditions for third-party purchaser retention).

³⁴ *See id.*

³⁵ *Id.* at 302-08 (Proposed Regulation § __.19)

§ __.19 Underwriting standards for qualifying CRE loans.

(a) General. The securitization transaction is collateralized solely (excluding cash and cash equivalents) by one or more CRE loans, each of which meets all of the requirements of paragraph (b) of this section.

(b) Underwriting, product and other standards.

(1) The CRE loan must be secured by a first lien on the commercial real estate.

(2) Prior to origination of the CRE loan, the originator:

(i) Verified and documented the current financial condition of the borrower;

(ii) Obtained a written appraisal of the real property securing the loan that:

(A) Was performed not more than six months from the origination date of the loan by an appropriately state-certified or state-licensed appraiser;

(B) Conforms to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board and the appraisal requirements²³⁰ of the Federal banking agencies; and

(C) Provides an “as is” opinion of the market value of the real property, which includes an income valuation approach that uses a discounted cash flow analysis;

(iii) Qualified the borrower for the CRE loan based on a monthly payment amount derived from a straight-line amortization of principal and interest over the term of the loan (but not exceeding 20 years);

(iv) Conducted an environmental risk assessment to gain environmental information about the property securing the loan and took appropriate steps to mitigate any environmental liability determined to exist based on this assessment;

(v) Conducted an analysis of the borrower’s ability to service its overall debt obligations during the next two years, based on reasonable projections;

(vi) Determined that, based on the previous two years’ actual performance, the borrower had:

(A) A DSC ratio of 1.5 or greater, if the loan is a qualifying leased CRE loan, net of any income derived from a tenant(s) who is not a qualified tenant(s);

(B) A DSC ratio of 1.5 or greater, if the loan is a qualifying multi-family property loan; or

(C) A DSC ratio of 1.7 or greater, if the loan is any other type of CRE loan;

(vii) Determined that, based on two years of projections, which include the new debt obligation, following the origination date of the loan, the borrower will have:

(A) A DSC ratio of 1.5 or greater, if the loan is a qualifying leased CRE loan, net of any income derived from a tenant(s) who is not a qualified tenant(s);

(B) A DSC ratio of 1.5 or greater, if the loan is a qualifying multi-family property loan; or

(C) A DSC ratio of 1.7 or greater, if the loan is any other type of CRE loan.

(3) The loan documentation for the CRE loan includes covenants that:

(i) Require the borrower to provide to the originator and any subsequent holder of the commercial loan, and the servicer, the borrower's financial statements and supporting schedules on an ongoing basis, but not less frequently than quarterly, including information on existing, maturing and new leasing or rent-roll activity for the property securing the loan, as appropriate; and

(ii) Impose prohibitions on:

(A) The creation or existence of any other security interest with respect to any collateral for the CRE loan;

(B) The transfer of any collateral pledged to support the CRE loan; and

(C) Any change to the name, location or organizational structure of the borrower, or any other party that pledges collateral for the loan;

(iii) Require the borrower and any other party that pledges collateral for the loan to:

(A) Maintain insurance that protects against loss on any collateral for the CRE loan, at least up to the amount of the loan,

and names the originator or any subsequent holder of the loan as an additional insured or loss payee;

(B) Pay taxes, charges, fees, and claims, where non-payment might give rise to a lien on any collateral for the CRE loan;

(C) Take any action required to perfect or protect the security interest of the originator or any subsequent holder of the loan in the collateral for the CRE loan or the priority thereof, and to defend such collateral against claims adverse to the originator's or subsequent holder's interest;

(D) Permit the originator or any subsequent holder of the loan, and the servicer, to inspect the collateral for the CRE loan and the books and records of the borrower or other party relating to the collateral for the CRE loan;

(E) Maintain the physical condition of the collateral for the CRE loan;

(F) Comply with all environmental, zoning, building code, licensing and other laws, regulations, agreements, covenants, use restrictions, and proffers applicable to the collateral;

(G) Comply with leases, franchise agreements, condominium declarations, and other documents and agreements relating to the operation of the collateral, and to not modify any material terms and conditions of such agreements over the term of the loan without the consent of the originator or any subsequent holder of the loan, or the servicer; and

(H) Not materially alter the collateral for the CRE loan without the consent of the originator or any subsequent holder of the loan, or the servicer.

(4) The loan documentation for the CRE loan prohibits the borrower from obtaining a loan secured by a junior lien on any property that serves as collateral for the CRE loan, unless such loan finances the purchase of machinery and equipment and the borrower pledges such machinery and equipment as additional collateral for the CRE loan.

(5) The CLTV ratio for the loan is:

(i) Less than or equal to 65 percent; or

(ii) Less than or equal to 60 percent, if the capitalization rate used in an appraisal that meets the requirements set forth in paragraph (b)(2)(ii) of this section is less than or equal to the sum of:

(A) The 10-year swap rate, as reported in the Federal Reserve Board H.15 Report as of the date concurrent with the effective date of an appraisal that meets the requirements set forth in paragraph (b)(2)(ii) of this section; and

(B) 300 basis points.

(6) All loan payments required to be made under the loan agreement are:

(i) Based on straight-line amortization of principal and interest over a term that does not exceed 20 years; and

(ii) To be made no less frequently than monthly over a term of at least ten years.

(7) Under the terms of the loan agreement:

(i) Any maturity of the note occurs no earlier than ten years following the date of origination;

(ii) The borrower is not permitted to defer repayment of principal or payment of interest; and

(iii) The interest rate on the loan is:

(A) A fixed interest rate; or

(B) An adjustable interest rate and the borrower, prior to or concurrently with origination of the CRE loan, obtained a derivative that effectively results in a fixed interest rate.

(8) The originator does not establish an interest reserve at origination to fund all or part of a payment on the loan.

(9) At the closing of the securitization transaction, all payments due on the loan are contractually current.

(10) (i) The depositor of the asset-backed security certifies that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the asset-backed security meet all of the requirements set forth in paragraphs (b)(1) through (9) of this section and has concluded that its internal supervisory controls are effective;

(ii) The evaluation of the effectiveness of the depositor's internal supervisory controls referenced in paragraph (b)(10)(i) of this section shall be performed, for each issuance of an asset-backed security, as of a date within 60 days of the cut-off date or similar date for establishing the composition of the asset pool collateralizing such asset-backed security; and

(iii) The sponsor provides, or causes to be provided, a copy of the certification described in paragraph (b)(10)(i) of this section to potential

investors a reasonable period of time prior to the sale of asset-backed securities in the issuing entity, and, upon request, to its appropriate Federal banking agency, if any.

(c) Buy-back requirement. A sponsor that has relied on the exception provided in paragraph (a) of this section with respect to a securitization transaction shall not lose such exception with respect to such transaction if, after the closing of the securitization transaction, it is determined that one or more of the CRE loans collateralizing the asset-backed securities did not meet all of the requirements set forth in paragraphs (b)(1) through (b)(9) of this section provided that:

(1) The depositor has complied with the certification requirement set forth in paragraph (b)(10) of this section;

(2) The sponsor repurchases the 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 ninety (90) days after the determination that the loans do not satisfy all of the requirements of paragraphs (b)(1) through (b)(9) of this section; and

(3) The sponsor promptly notifies, or causes to be notified, the holders of the asset-backed securities issued in the securitization transaction of any loan(s) included in such securitization transaction that is required to be repurchased by the sponsor pursuant to paragraph (c)(2) of this section, including the principal amount of such repurchased loan(s) and the cause for such repurchase.

As described, among the most notable criteria are the finite numeric ones such as the DSC ratio of 1.5-1.7 or better depending on the property type, and the CLTV ratio of less than or equal to 65%. It is interesting that the regulators determined that it was possible to establish such bright-line rules to define “safe” loans, considering the heterogeneous nature of CRE lending. An important issue to consider is whether the market concurs that these parameters do indeed reflect “safe” loans. Other deviations from typical industry practice to be aware of include the requirement that loan payments be amortized over 20 years (rather than 30), and the prohibition on mezzanine financing. Note also should be taken of the buy-back requirement that would be required for the sponsor to maintain the risk retention exemption of any loans are subsequently determined not to comply with the qualifying loan criteria.

While a number of the qualifying loan criteria are probably ones already employed in the commercial space (e.g., have an appraisal; adequately insure the property), the proposal should be examined closely to determine whether, viewed in totality, the exemption criteria are so conservative that the exemption will prove useless, or whether they are appropriately calibrated.

Lastly, it should be kept in mind that the proposed underwriting criteria for “qualifying” loan pools are not necessarily the only avenue to obtaining an exemption from the risk retention rules. The statute contemplates a process for seeking exemptions for particular deals, asset classes, or structures, and the proposed rule notes that the appropriate regulatory agencies “will jointly approve any

exemptions, exceptions, or adjustments to the final rules.”³⁶ Indeed, the Risk Retention NPRM specifically seeks comment on whether there are other types of securitization transactions that should be covered by the exemptions, and asks for specific information on the features and characteristics of such securitization transactions that would make them appropriate candidates for an exemption.³⁷ It follows that consideration should be given to whether additional frameworks, such as use of industry-standard representations and warranties like those developed by CREFC, should be proposed as an alternative form of risk retention for CMBS.

C. Questions to Consider Regarding the CMBS-Specific Provisions

Some of the significant issues and questions raised by the CMBS-Specific Provisions that warrant close study and potential comment are:

- Whether multiple B-piece buyers can share the risk retention obligation;
- Whether a sponsor and B-piece buyer could share the retention obligation;
- The impact of the independent operating advisor requirement for B-piece buyer/special servicers seeking to retain the mandated interest;
- Whether the parameters for qualifying as an exempt CRE loan pool are too restrictive, or are appropriately calibrated; and,
- Whether additional frameworks, such as use of industry-standard representations and warranties, should be proposed as an alternative form of risk retention for CMBS.

* * *

To provide a complete description of the questions asked by the regulators in the Risk Retention NPRM, the following Appendix contains all of those questions, verbatim, grouped by relevant subject matter. Questions dealing with irrelevant subjects such as the residential qualified mortgage standards are not included. The question numbers below correspond to those appearing in the NPRM.

³⁶ *Id.* at 25.

³⁷ *See id.* at 196-97.

APPENDIX – QUESTIONS FROM RISK RETENTION NPRM

General Definitions and Scope

1. Do the proposed rules appropriately implement the terms “securitizer” and “originator” as used in section 15G and consistent with its purpose?
2. Are there other terms, beyond those defined in §__.2 of the proposed rules, that the Agencies should define?
- 3(a). As a general matter, is it appropriate to impose the risk retention requirements on the sponsor of an ABS transaction, rather than the depositor for the transaction? 3(b). If not, why?
- 4(a). With respect to the terms defined, would you define any of the terms differently?
- 4(b). If so, which ones would you define differently, and how would you define them? For example, credit risk is defined to mean, among other things, the risk of loss that could result from failure of the issuing entity to make required payments or from bankruptcy of the issuing entity.
5. Is it appropriate for the definition of credit risk to include risk of non-payment by the issuing entity unrelated to the assets, such as risk that the issuing entity is not bankruptcy remote?
6. Are all of the definitions in §__.2 of the proposed rules necessary? For instance, is a definition of “asset” necessary?
- 7(a). As proposed, where two or more entities each meet the definition of sponsor for a single securitization transaction, the proposed rules would require that one of the sponsors retain a portion of the credit risk of the underlying assets in accordance with the requirements of the rules. Is this the best approach to take when there are multiple sponsors in a single securitization transaction?
- 7(b). If not, what is a better approach and why? For example, should all sponsors be required to retain credit risk in some proportional amount, should the sponsor selling the greatest number of assets or with a particular attribute be required to retain the risk, or should the proposed rules only allow a sponsor that has transferred a minimum percentage (e.g., 10 percent, 20 percent, or 50 percent) of the total assets into the trust to retain the risk?
- 8(a). Should the proposed rules allow for allocation of risk to a sponsor (among multiple sponsors in a single transaction) similar to the proposed rules’ parameters for allocation of risk among multiple originators?
- 8(b). Why or why not?
9. A securitization transaction is proposed to be defined as a transaction involving the offer and sale of asset-backed securities by an issuing entity. In a single securitization transaction, there may be intermediate steps; however, the proposed rules would only require the sponsor to retain risk for the securitization transaction as a whole. Should the rules provide additional guidance for when a transaction with intermediate steps constitutes one or more securitization transactions that each should be subject to the rules’ risk retention requirements?

General Risk Retention Requirement

10. The Agencies request comment on whether the minimum five percent risk retention requirement established by the proposed rules for non-exempt ABS transactions is appropriate, or whether a higher

risk retention requirement should be established for all non-exempt ABS transactions or for any particular classes or types of non-exempt ABS.

11. If a higher minimum requirement should be established, what minimum should be established and what factors should the Agencies take into account in determining that higher minimum? For example, should the amount of credit risk be based on expected losses, or a market-based test based on the interest rate spread relative to a benchmark index?

12(a). Would the minimum five percent risk retention requirement, as proposed to be implemented, have a significant adverse effect on liquidity or pricing in the securitization markets for certain types of assets (such as, for example, prudently underwritten residential mortgage loans that do not satisfy all of the requirements to be a QRM)?

12(b). If so, what markets would be adversely affected and how? What adjustments to the proposed rules (e.g., the minimum risk retention amount, the manner in which credit exposure is measured for purposes of applying the risk retention requirement, or the form of risk retention) could be made to the proposed rules to address these concerns in a manner consistent with the purposes of section 15G? Please provide details and supporting data.

Permissible Forms of Risk Retention

13. Is the proposed menu of options approach to risk retention, which would allow a sponsor to choose the form of risk retention (subject to all applicable terms and conditions), appropriate?

14(a). Should the Agencies mandate that sponsors use a particular form of risk retention (e.g., a vertical slice or a horizontal slice) for all or specific types of asset classes or specific types of transactions?

14(b). If so, which forms should be required for with which asset classes and why?

15. Does the proposed menu approach achieve the objectives of the statute to provide securitizers an incentive to monitor and control the underwriting quality of securitized assets and help align incentives among originators, sponsors, and investors?

16. Is each of the proposed forms of risk retention appropriate? In particular, the Agencies seek comment on the potential effectiveness of the proposed forms of risk retention in achieving the purposes of section 15G, their potential effect on securitization markets, and any operational or other problems these forms may present.

17. Are there any kinds of securitizations for which a particular form of risk retention is not appropriate?

18. How effective would each of the proposed risk retention options be in creating incentives to monitor and control the quality of assets that are securitized and in aligning the interests among the parties in a securitization transaction?

19(a). Are there other forms of risk retention that the Agencies should permit?

19(b). If so, please provide a detailed description of the form(s), how such form(s) could be implemented, and whether such form(s) would be appropriate for all, or just certain, classes of assets.

20. Should the proposed rules require disclosure as to why the sponsor chose a particular risk retention option?

21(a). Are there ways that sponsors could avoid the risk retention requirements in an effort to reduce or eliminate their risk retention requirements?

- 21(b). If so, how should we modify the proposed rules to address this potential?
22. Are the methodologies proposed for calculating the required five percent exposure under each of the options appropriate?
- 23(a). Are there other ways that the minimum five percent requirement should be calculated?
- 23(b). Would such calculation methods be difficult to enforce?
- 23(c). If so, how can we address those difficulties?
- 23(d). Are there other alternatives?

Vertical risk retention

24. Are the disclosures proposed sufficient to provide investors with all material information concerning the sponsor's retained interest in a securitization transaction, as well as to enable investors and the Agencies to monitor the sponsor's compliance with the rule?
- 25(a). Should additional disclosures be required?
- 25(b). If so, what should be required and why?
26. Are there any additional factors, such as cost considerations, that the Agencies should consider in formulating an appropriate vertical risk retention option?

Horizontal risk retention

27. Do the conditions and limitations in the proposed rules effectively limit the ability of the sponsor to structure away its risk exposure?
- 28(a). Is the restriction on certain payments to the sponsor with respect to the eligible horizontal residual interest appropriate and sufficient?
- 28(b). Why or why not?
- 29(a). Is the proposed approach to measuring the size of horizontal risk retention (five percent of the par value of all ABS interests in the issuing entity that are issued as part of the securitization transaction) appropriate?
- 29(b). Would a different measurement be better? Please provide details and data supporting any alternative measurements.
30. Are the disclosures proposed sufficient to provide investors with all material information concerning the sponsor's retained interest in a securitization transaction, as well as enable investors and the Agencies to monitor whether the sponsor has complied with the rule?
- 31(a). Should additional disclosures be required?
- 31(b). If so, what should be required and why?
32. Are there any additional factors, such as accounting or cost considerations that the Agencies should consider with respect to horizontal risk retention?
33. Should a sponsor be prohibited from utilizing the horizontal risk retention option if the sponsor (or an affiliate) acts as servicer for the securitized assets?
34. Are the terms and conditions of the horizontal cash reserve account appropriate?

35. Do the terms and conditions ensure that such an account will expose the sponsor to the same type and amount of credit risk and have the same incentive effects as an eligible horizontal residual interest?

36(a). Should the eligible horizontal residual interest be required to be structured as a “Z bond” such that it pays no interest while principal is being paid down on more senior interests?

36(b). Why or why not?

L-Shaped risk retention

37. Are the disclosures proposed sufficient to provide investors with all material information concerning the sponsor’s retained interest in a securitization transaction, as well as enable investors and the Agencies to monitor whether the sponsor has complied with the rule?

38(a). Should additional disclosures be required?

38(b). If so, what should be required and why?

39. Are there any additional factors, such as cost considerations, that the Agencies should consider with respect to L-shape risk retention?

40(a). Should the Agencies permit or require that a higher proportion of the risk retention held by a sponsor under this option be composed of a vertical component or a horizontal component?

40(b). What implications might such changes have on the effectiveness of the option in helping achieving the purposes of section 15G?

Commercial mortgage-backed securities (Retention by B-piece Buyer)

68(a). Should the rules allow a third-party purchaser to retain the required amount of risk in a CMBS transaction as described above?

68(b). Why or why not?

69(a). Should a third-party purchaser option be available to other asset classes besides CMBS? Would expanding this option to other asset classes fulfill the purposes of section 15G?

69(b). If so, would any adjustments or requirements be necessary?

70. Should the use of this option be conditioned, as proposed, on a requirement that the third-party purchaser separately examine the assets in the pool and/or not sell or hedge the interest it is required to retain?

71(a). Should the use of this option be conditioned, as proposed, on the requirement that the sponsor disclose the actual purchase price paid by the third-party purchaser for the eligible horizontal residual interest?

71(b). Why or why not?

72. Is any disclosure concerning the financial resources of the third-party purchaser necessary in light of the requirement that the third-party purchaser fund the acquisition of the eligible horizontal residual interest in cash without direct or indirect financing from a party to the transaction?

73(a). Should the rule specify the particular types of information about a third-party purchaser that should be disclosed, rather than requiring disclosure of any other information regarding the third-party

purchaser that is material to investors in light of the circumstances of the particular securitization transaction?

3(b). Should the specific types of information about a third-party purchaser be in addition to any other information regarding the third-party purchaser that is material to investors in light of the circumstances of the particular securitization transaction?

74. Are the conditions relating to servicing, including those related to an Operating Advisor, appropriate or should they be modified or supplemented?

75(a). Should the Agencies require any other disclosure relating to representations and warranties concerning the assets for CMBS?

76(a). We are aware of at least one industry group developing model representations and warranties for CMBS. Should the rule require that a blackline of the representations and warranties for the securitization transaction against an industry-accepted standard for model representations and warranties be provided to investors at a reasonable time prior to sale?

76(b). Would this provide more information regarding the adequacy of the representation and warranties being provided?

76(c). Would this be a costly requirement?

76(d). Could investors easily create their own blacklines if needed?

77. Are the disclosures proposed sufficient to provide investors with all material information concerning the third-party purchaser's retained interest in the securitization transaction, as well as to enable investors and the Agencies to monitor whether the sponsor has complied with the rule?

78(a). Should additional disclosures be required?

78(b). If so, what should be required and why?

Treatment of government-sponsored enterprises

79. Is our proposal regarding the treatment of the Enterprises appropriate?

80. Would applying the hedging prohibition to all of the credit risk that the Enterprises are required to retain when using § ____.11 to satisfy the risk retention requirements be an unduly burdensome result for the Enterprises?

81(a). Instead of the broad exception from the hedging prohibition for the Enterprises, when satisfying the risk retention requirements pursuant to § ____.11, should the rules prohibit an Enterprise from hedging five percent of the total credit risk in any securitization transaction where the Enterprise acts as a sponsor (thus ensuring the Enterprise retains at least that amount of exposure to the credit risk of the assets)?

81(b). Would this be consistent with statutory intent?

81(c). Would that be feasible for the Enterprises to monitor?

Allocation to the originator

86(a). Should the proposed rules permit allocation to originators where the sponsor is using other menu options, such as the L-shaped risk retention option in § __6. of the proposed rules, and if so, under what specific conditions and requirements? 86(b). In what cases is it likely that this alternative

approach actually would be used? 86(c). What are the specific benefits of an alternative approach, and do they outweigh concerns regarding complexity?

87. Should the rule permit allocation to originators if the sponsor elects the horizontal cash reserve account option in proposed § __.5(b)?

88(a). Should the proposed rules permit allocation of risk to originators that have originated less than 20 percent of the asset pool?

88(b). Alternately, is the minimum 20 percent threshold sufficient to ensure that an originator allocated risk has an incentive to monitor the quality of the entire collateral pool?

89(a). Are there alternative mechanisms for allocating risk to an originator that should be permitted by the Agencies? For example, should the rules permit or require that an originator that is allocated risk retention by a sponsor retain exposure only to the assets that the originator itself originates?

89(b). If so, how might such an allocation mechanism feasibly be structured, incorporated into the rule, and monitored by investors and supervisors?

90. Should the rules permit sponsors to allocate risk to a third party, and if so, how to ensure that incentives between the sponsor and investors are aligned in a manner that promotes quality underwriting standards?

91. Are the proposed disclosures sufficient to provide investors with all material information concerning the originator's retained interest in a securitization transaction, as well as to enable investors to monitor the originator(s) and the Agencies to assess the sponsor's compliance with the rule?

92(a). Should additional disclosures be required?

92(b). If so, what should be required and why?

93(a). As proposed, the retaining sponsor is responsible for compliance with the rule and must maintain and adhere to policies and procedures reasonably designed to monitor compliance by each originator retaining credit risk, including the anti-hedging restrictions.

93(b). What are the practical implications if the originator fails to comply?

94(a). To help ensure that the originator has sufficient incentive to retain its interest in accordance with the rule, should the rule require that a sponsor obtain a contractual commitment from the originator to retain the interest in accordance with the rule?

94(b). If so, how should the Agencies implement this requirement?

95. Are there other methods that could be implemented to help ensure that a sponsor satisfies its obligations under the rule?

Hedging, transfer and financing restrictions

96(a). Under the proposal, a sponsor would not be permitted to sell or otherwise transfer any interest or assets that the sponsor is required to retain to any person other than an entity that is and remains a consolidated affiliate. Is the permitted transfer to consolidated affiliates appropriate?

96(b). Why or why not?

97. Is the proposed hedging prohibition appropriately structured?

98(a). Would the proposal inadvertently capture any kinds of hedging that should be permissible?

98(b). If so, please provide specific recommendations on how we can appropriately tailor the requirements.

99. Does the proposed approach appropriately implement the statutory requirement to prohibit direct and indirect hedging?

100(a). Does the proposal permit hedging that is inconsistent with risk retention and should be prohibited?

100(b). If so, please provide specific recommendations on how we can more appropriately tailor the requirements.

101. Are the proposed provisions concerning the pledging of retained assets appropriate? Should the rule instead prohibit the pledging of retained assets even where the financial transaction is recourse to the sponsor or consolidated affiliate?

102(a). Under the proposal, a sponsor (or a consolidated affiliate) would be prohibited from transferring the retained interest or assets until the retained interest or assets were fully repaid or extinguished. Is this appropriate, or should a sponsor be permitted to freely transfer or hedge its retained exposure after a specified period of time?

102(b). If so, should a period of time be established for different types of securitizations?

103. Are the proposal's requirements pertaining to index hedging appropriate?

104. Are the 10 percent and 20 percent thresholds discussed above consistent with market practice and the underlying goals of the statutory risk retention requirements?

105. Should credit protection and hedging by the issuing entity of any portion of the credit risk on the securitized assets be permitted or, because such credit protection and hedges could limit the incentive of investors to conduct due diligence on the securitized assets, should all credit protection and hedging by the issuing entity (other than interest rate and currency risk) be prohibited?

ABS collateralized exclusively by qualifying CRE loans, commercial loans, or auto loans

153. The Agencies request comment on the appropriateness of a total exemption for sponsors of ABS issuances collateralized exclusively by qualifying CRE, commercial, or automobile loans that meet the underwriting standards set forth in §__.18 to §__.20 of the proposed rules. Commenters who support a partial exemption are encouraged to provide information regarding the methodology the Agencies should use to calibrate the retention requirement, in a manner that considers the relative risk of the securitization transaction, both within and across the proposed asset classes.

"Qualifying"/Exempt CRE loan pools

156(a). Are the proposed requirements for a qualifying CRE loan appropriate?

156(b). Are these standards sufficient to ensure that qualifying CRE loans have very low credit risk?

157. Are the DSC metrics employed for measuring a borrower's financial capacity, and the specified parameter for each type of CRE property, an appropriate standard?

158. The Agencies are proposing the same DSC ratio (1.5) for qualifying leased CRE loans and qualifying multifamily CRE loans, where the DSC analysis is based on at least two years of actual performance. The Agencies request comment whether the risk of default for qualifying non-Enterprise multifamily CRE loans is demonstrably lower as to justify a lower DSC ratio (such as 1.3). For

example, the Agencies acknowledge that several highly-publicized defaults on large multifamily CRE loans had a much weaker structure (e.g., pro-forma underwritten DSC ratio or DSC ratio lower than 1.2) than what is contained in the proposed rules. Commenters should provide relevant criteria to be applied to qualify for a reduced DSC ratio and multifamily CRE loan performance data supporting the conclusion that multifamily loans meeting such criteria, as a class, have a correspondingly reduced risk of default to support a reduced DSC ratio for such loans.

161(a). The Agencies seek comment on whether the sponsor should be required to repurchase the entire pool of loans collateralizing the ABS if the amount or percentage of the loans that are required to be repurchased due to the failure to meet the underwriting standards under §__.18, §__.19 or §__.20, as applicable, of the proposed rules reaches a certain threshold.

161(b). If so, what threshold would be appropriate?

Exemption for certain resecuritization transactions

168(a). Are there other types of resecuritization transactions backed solely by 15G-compliant ABS that should be exempt from the risk retention requirements?

168(b). If so, what principles and factors should the Agencies use in considering whether other types of resecuritizations backed by 15G-compliant ABS should be exempted from the risk retention requirements of section 15G?

168(c). Should the Agencies consider granting an exemption only if it is clear that the resecuritization transaction does not expose investors in the resecuritization to different levels or types of credit risk in the securitized assets than the underlying 15G-compliant ABS?

169(a). Should the rule provide an exemption for a sequential-pay resecuritization that is collateralized only by 15G-compliant ABS? In this type of resecuritization, the rights to principal repayment of the holders of the different classes differ solely with respect to the timing of such repayments. Longer duration classes receive no payments of principal until shorter duration classes have been paid off in full and principal shortfalls are allocated on a pro-rata basis based upon the unpaid principal balance of each class. As the shorter duration classes are paid off, the unpaid principal balances of the longer duration classes begin to represent a larger portion of the total unpaid principal balances of the underlying ABS and, therefore, the longer duration classes are allocated an ever-increasing percentage of credit losses as the ABS matures.

169(b). If an exemption for sequential-pay resecuritizations backed by 15G-compliant ABS is appropriate, how could such an exemption be written to ensure the exemption is limited to this particular structure?

170(a). Should the Agencies provide an exemption for prepayment-tranched resecuritizations that are backed solely by 15G-compliant ABS? This form of resecuritization involves the sponsor of the resecuritization creating tranches based on the prepayments of the underlying ABS (i.e., prepayments received by the ABS in the first-level ABS securitization). One type of prepayment-tranched resecuritization is a planned amortization class (PAC) resecuritization. PAC bonds receive principal payments based on the level of prepayments and will have their expected duration if the actual speed of prepayments on the underlying ABS falls within a designated range. In order to create a PAC bond with greater certainty of cash flow than the underlying ABS, one or more support (SUP) classes that are highly sensitive to varying levels of prepayment are created as part of the same transaction. If the rate of prepayments is faster than that assumed in the creation of the PAC, the SUPs receive more principal in order to prevent an overpayment of principal on the PAC. If the rate of prepayment is

slower, principal is redirected from the SUPs in order to achieve the specified repayment schedule on the PAC. In either case, credit losses are allocated on a pro rata basis based on the unpaid principal balance attributable to each class. Accordingly, the effect of faster-than-expected rates of prepayment will tend to expose holders of the PAC bonds to relatively greater losses than the holders of the SUPs, while slower-than-expected rates of prepayment will tend to have the opposite effect. Moreover, in transactions where more than one PAC bond is created, the distribution of principal repayments to the PACs are based on priority and, therefore, the holders of the PACs are exposed to levels of credit risk that differ from that of the underlying ABS.

170(b). If an exemption of prepayment-tranched resecuritizations or certain types of such resecuritizations (such as PAC structures) is appropriate, how could an exemption be written to ensure that the exemption does not extend to other resecuritizations?

171. As noted above, the proposed exemptions require the underlying ABS be 15G-compliant ABS. In practice, initially this may mean that only resecuritizations based on ABS guaranteed by Fannie Mae and Freddie Mac will qualify for this exemption. Does this raise any competitive or other issues and if so, how can they be mitigated without eliminating the requirement there be risk retention on the underlying ABS?

172(a). Is the proposed language for this exemption appropriate?

172(b). Does any portion of the exemption cause an ambiguity that should be addressed?

Additional exemptions

Consistent with section 15G of the Exchange Act, § __.23(b) of the proposed rules provides that the Federal banking agencies and the Commission, in consultation with FHFA and HUD, may jointly adopt or issue additional exemptions, exceptions or adjustments to the credit risk retention requirements, including exemptions, exceptions or adjustments for classes of institutions or assets in accordance with section 15G(e).¹⁹⁵ In addition, § __.23(a) of the proposed rules recognizes that the Agencies with rulewriting authority under section 15G(b)¹⁹⁶ with respect to the type of assets involved may jointly provide a total or partial exemption of any individual securitization transaction, as such Agencies determine may be appropriate in the public interest and for the protection of investors, as permitted by section 15G(c)(1)(G)(i).¹⁹⁷ The Agencies expect to coordinate with each other to facilitate the processing, review and action on requests for such written interpretations or guidance, or additional exemptions, exceptions or adjustments.

173(a). Are there securitization transactions that would not be covered by the exemptions in the proposed rules that should be exempted from risk retention requirements pursuant to section 15G(e)(3) of the Exchange Act?

173(b). If so, what are the features and characteristics of such securitization transactions that would properly exempt them from risk retention requirements pursuant to section 15G(e)(3)?

Safe harbor for certain foreign-related transactions

174(a). Are there any extra or special considerations relating to these circumstances that we should take into account?

174(b). Should the more than 10 percent proceeds trigger be higher or lower (e.g., 0 percent, 5 percent, 15 percent, or 20 percent)?

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