

Risk Retention Proposed Rule: Background and Summary

I. Section 941(b) of the Dodd-Frank Act

- Section 941(b) of the Dodd-Frank Act¹ creates section 15G of the Securities Exchange Act. New section 15G requires the OCC, FRB, FDIC, and SEC² to issue joint regulations requiring securitizers of asset-backed securities (ABS) to retain an unhedged economic interest in a portion of the credit risk (not less than 5%) for assets that the securitizer packages into the securitization for sale to others, except where those assets are underwritten according to underwriting standards established by regulation.
- Where these regulations address the securitization of residential mortgage assets, HUD and the FHFA also are part of the joint rulemaking group. The Treasury Secretary, as Chairperson of FSOC, is directed to coordinate the joint rulemaking.
- The agencies are directed to define the appropriate form and amount of risk retention interests, to consider circumstances in which it might be appropriate to shift the retention obligation to the originator of the securitized assets, and to create rules addressing complex securitizations backed by other asset-backed securities.
- The agencies also must implement the statutory exemption from the risk retention requirements for “qualified residential mortgages” (QRMs) with underwriting and product features that historical loan performance data indicate result in a lower risk of default. Securities backed entirely by QRMs are not subject to any risk retention requirement.
- Section 15G also requires the agencies to establish underwriting standards indicative of low credit risk for other asset classes used in securitizations, including auto loans, commercial loans, and commercial real estate loans. Securitizations backed by assets that meet these standards may be subject to less than 5% risk retention.

II. Overall Approach

- The proposed rule prescribes underwriting criteria for QRMs and certain other asset classes, and provides that sponsors of securitizations comprised of these “qualified assets” are not required to retain risk under section 15G.

¹ New section 15G will be codified at 15 U.S.C. § 78o-11.

² The OTS, which is abolished by the Dodd-Frank Act, is not one of the rulemaking agencies. The preamble to the proposal, at note 26, describes how the risk retention rule will be applied to Federal and state savings associations.

Consistent with the statutory purpose of requiring “skin in the game” for all but the least risky assets, the QRM underwriting standards are conservative. The proposed standards also are designed to be unambiguous; they draw “bright lines” in order to facilitate transparency and enable verification by securitization sponsors and investors.

- While the risk retention exemptions under the proposal are conservative, the proposal also contains various options for how the risk retention requirements can be satisfied for non-exempt assets. A securitizer may then choose, based on the type of asset involved and market and investor expectations, which form of risk retention to use. The agencies intended that these options would provide flexibility so that the risk retention requirements not impede the reemergence of robust securitization markets for non-exempt loans.
- Comments received during the public comment process will be vital to the agencies in evaluating the appropriate stringency of standards for QRMs and other categories of assets exempt from risk retention, and whether the flexibility of the multiple risk retention options proposed would achieve the agencies’ objective of not impeding securitization activities for non-exempt asset classes.

III. Description of the proposal

A. Underwriting Standards

1. Qualified Residential Mortgages (QRMs)

- *Historical Data.* The proposed rule establishes the terms and conditions under which a residential mortgage would qualify as a QRM. As required by the statute, the agencies developed these underwriting criteria through evaluation of historical loan performance data, which is described, in detail, in the preamble to the proposal.
- *Nontraditional Product Features.* The proposed rule generally would prohibit QRMs from having product features that add complexity and risk to mortgage loans, such as terms permitting negative amortization, interest-only payments, or significant interest rate increases.
- *Underwriting Standards.* The proposed definition of QRM would establish conservative underwriting standards designed to ensure that QRM loans are of very high credit quality. These standards include:
 - Maximum front-end and back-end borrower debt-to-income ratios of 28% and 36%, respectively;
 - A maximum loan-to-value (LTV) ratio of 80% in the case of a purchase transaction (with a 75% combined LTV for refinance transactions, reduced to 70% for cash-out refis);
 - A 20% down payment requirement in the case of a purchase transaction;

and

- Borrower credit history restrictions, including no 60-day delinquencies on any debt obligation within the previous 24 months.
- *Mortgage Insurance.* The LTV ratio must be calculated without considering mortgage insurance. Although mortgage insurance protects investors from losses when borrowers default, and thus lessens the severity of the loss, the statute directs the agencies, in developing the QRM criteria, to consider whether mortgage insurance reduces the risk that default will occur in the first place.
 - The preamble requests comment on the use of mortgage insurance and asks commenters to provide historical loan performance data or studies and other factual support for their views. The agencies will be particularly interested in data indicating whether mortgages with mortgage insurance are less likely to default than other mortgages, after adequately controlling for loan underwriting or other factors known to influence credit performance.
- *Servicing Requirements.* The proposal includes in the criteria for a QRM a limited set of servicing requirements that may lower the risk of default on residential mortgages. The proposal requires that the originator of a QRM incorporate in the mortgage transaction documents certain requirements regarding servicing policies and procedures for the mortgage, including procedures for loss mitigation actions, and procedures to address subordinate liens on the same property securing other loans held by the same creditor.
 - The servicing requirements focus on establishing a process for the creditor to take loss mitigation activities into account in servicing QRMs, but they do not dictate particular types of actions to be undertaken, and they factor in consideration of the relative estimated economic impacts on the QRM of loss mitigation versus other approaches in dealing with distressed loans.
 - The servicing requirements included in this proposal cannot supplant the ongoing interagency effort to develop national mortgage servicing standards. Those national mortgage servicing standards would apply to residential mortgages regardless of whether the mortgages are QRMs, are securitized, or are held in portfolio by a financial institution. The primary objective of this separate interagency effort is to develop a comprehensive, consistent, and enforceable set of servicing standards for residential mortgages that all servicers would have to meet. Also, the separate interagency effort is taking into consideration a number of aspects not included in the QRM servicing standards, including 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 proposal also requests comment on whether this national approach is a more effective way to address problems of servicing than the proposed QRM criteria.

- *Alternative Approach.* The preamble also requests comment an alternative approach that would apply less conservative underwriting standards to QRMs, including lower down payments and the use of private mortgage insurance, and would increase the risk retention requirements for non-QRM mortgages.

2. Other “qualified assets”

- The proposed rule also would not require a securitizer to retain any portion of the credit risk associated with a securitization transaction if the ABS issued are exclusively collateralized by auto loans, commercial loans, or commercial real estate loans that meet underwriting standards included in the proposed rule.³ The underwriting standards proposed under this provision of 15G have been designed to be robust and ensure that the loans backing the ABS are of very low credit risk. They were developed by the Federal banking agencies based on supervisory expertise.
- *Auto Loan Asset Class.* Given the highly depreciable nature of the collateral for auto loans, the underwriting standards associated with the auto loan asset class focus primarily on the borrower’s ability to repay the loan, comparable to industry standards for unsecured lending.
- *Commercial Loan Asset Class.* The underwriting standards associated with the commercial loan asset class are designed to assure that the borrower’s business is in, and will remain in, sound financial condition and maintain the ability to repay the loan.
- *Commercial Real Estate Loan Asset Class.* The underwriting standards associated with the commercial loan asset class are designed to ensure that the property securing the loan is stable and provides sufficient net operating income to repay the loan, and recognize the relatively lower risk presented by stabilized properties and multi-family properties with established tenants.
- *Residential Mortgage Asset Class.* Section 15G also contemplates a residential mortgage asset class with reduced risk retention comparable to the proposed rules for auto loans, commercial loans, and commercial real estate loans. The agencies are not proposing a different set of residential mortgage underwriting standards than the QRM standards at this time. One issue that would be raised by an additional residential mortgage asset class

³ Rather than providing an outright exemption, section 15G(c)(1)(B)(ii) provides that a sponsor of an ABS issuance collateralized exclusively by loans that meet the underwriting standards prescribed by the Federal banking agencies under section 15G(c)(2)(B) shall be required to retain “less than five percent of the credit risk” of the securitized loans. The proposal sets that number at zero percent. The agencies were concerned that establishing a risk retention requirement between zero and five percent for qualifying assets within these asset classes may not provide sufficient incentives for securitizers to allocate the resources necessary to ensure that the collateral backing an ABS issuance satisfies the proposed underwriting standards, as there may be significant compliance costs to structure and maintain the retention piece of a securitization structure (irrespective of how it is calibrated) and provide required disclosures to investors. The underwriting standards the agencies propose are conservative, as is appropriate for a zero percent risk retention requirement.,

is whether the risk retention requirement should be higher than zero, and whether such a retention level would provide adequate incentive for underwriting mortgages meeting the underwriting standards for the class.

- The agencies are requesting comment whether a residential mortgage asset class should be created, whether private mortgage insurance should be included, what other appropriate underwriting criteria might apply, and what level of risk retention would be appropriate.
- *Other Asset Classes.* The agencies have the authority to develop underwriting rules for more asset classes, but the agencies are not proposing to do so at this time. Although there are additional asset classes in the ABS market, they exhibit significant differences among underwriting factors for different loans within the class, or tend to be higher risk assets. As a practical matter, this makes it difficult to establish robust underwriting standards for an entire class through regulation. Moreover, the agencies' proposed risk retention alternatives present a great deal of flexibility that should facilitate securitization activities in these other asset classes.

3. Quality Control

- The proposal contains two provisions to guard against abuse of the QRM and other qualifying asset exemptions.
 - First, the process of selecting and assembling the assets for securitization must be performed according to adequate internal supervisory controls to ensure they were underwritten in accordance with the rule, and the sponsor must provide a self-certification as to the adequacy of these controls to potential investors in the securitization.
 - Second, if any of the loans are subsequently determined not to have been underwritten in accordance with the standards, the sponsor must buy them back from the pool for cash (at unpaid principal balance plus accrued interest) within 90 days.

4. Other exempt assets

- *Federal and State Guarantees.* Consistent with section 15G, the proposed rule also exempts government-guaranteed securitizations and assets from the risk retention requirements.
- *Pass-through Re-securitization Transactions.* The rule also exempts single class re-securitizations providing for the pass-through (net of expenses) of principal and interest received on underlying asset-backed securities for which credit risk already has been retained in accordance with section 15G (or which were exempt).

B. General Risk Retention Requirements

1. Scope of Application.

- *Sponsor.* The proposed rules generally require that a securitization “sponsor,” or one of its consolidated affiliates, hold the required risk retention. Practically speaking, of all the various parties involved in a typical securitization transaction, the “sponsor” is the true decision-maker behind the securitization transaction and determines what assets will be securitized. In light of this, the proposed rule provides that a sponsor of an ABS transaction is the party required to retain the risk under the rule. The proposed rule defines the term “sponsor” in a manner consistent with the definition of that term in the SEC’s Regulation AB.
- *Originator.* The proposed rule would permit a securitization sponsor to allocate a proportional share of the risk retention obligation to the originator(s) of the securitized assets, subject to certain conditions. This would have to be voluntary on the originator’s part, however, through a contractual agreement with the sponsor.
 - The proposed rule defines “originator” as the person that “creates” a loan or other receivable. This only covers the original creditor—and not a subsequent purchaser or transferee.
 - To ensure the originator has “skin in the game,” the proposal requires the originator to be the originator for at least 20 percent of the loans in the securitization, take on at least 20 percent of the risk retention, and pay up front for its share of retention, either in cash or a discount on the price of the loans the originator sells to the pool.

2. Acceptable Forms of Risk Retention.

- Consistent with the statute, the proposed rule generally would require a sponsor to retain an economic interest equal to at least 5% of the aggregate credit risk of the assets collateralizing an issuance of ABS (the “base” risk retention requirement). The agencies have sought to structure the proposed risk retention requirements in a flexible manner that will allow the securitization markets for non-qualified assets to function in a manner that both facilitates the flow of credit to consumers and businesses on economically viable terms and is consistent with the protection of investors.
- The proposed rule provides several options for the form in which a securitization sponsor may retain risk. These include:
 - A 5% “vertical” slice of the ABS interests, whereby the sponsor or other entity retains a specified *pro rata* piece of each class of interests issued in the transaction (that is, the sponsor must hold 5% of each tranche);

- A 5% “horizontal” first-loss position, whereby the sponsor or other entity retains a subordinate interest in the issuing entity that bears losses on the assets before any other classes of interests;
- An “L-shaped interest” interest whereby the sponsor holds at least half of the 5% retained interest in the form of a vertical slice and half in the form of a horizontal first-loss position;
- A “seller’s interest” in securitizations structured using a master trust collateralized by revolving assets whereby the sponsor or other entity holds a 5% separate interest that participates in revenues and losses on the same basis as the investors’ interest in the pool of receivables (unless and until the occurrence of an early amortization event);
- A representative sample, whereby the sponsor retains a 5% representative sample of the assets to be securitized, thereby exposing the sponsor to credit risk that is equivalent to that of the securitized assets; or
- For certain “eligible” single-seller or multi-seller asset-backed commercial paper conduits collateralized by loans and receivables and covered by a 100% liquidity guarantee from a regulated bank or holding company, a 5% residual interest retained by the receivables’ originator-seller. This option would not be available to ABCP programs that operate as SIVs or securities arbitrage programs.
- The rule also provides that Fannie Mae and Freddie Mac will be able to satisfy the risk retention requirement through their guarantees (which cover 100% of principal and interest) as long as they continue to operate under the conservatorship or receivership of the FHFA and with direct government support through the Treasury Department’s Senior Preferred Stock Purchase Agreement.
- *Premium capture cash reserve account.* In addition to the base credit risk retention requirement, the proposed rule would prohibit sponsors from receiving compensation in advance for excess spread⁴ income to be generated by securitized assets over time. The proposed rules accomplish this by imposing a “premium capture” mechanism designed to prevent a securitizer from structuring an ABS transaction in a manner that would allow the securitizer to take an up-front profit on a securitization (before any unexpected losses on the securitized assets appeared) that would pay the sponsor more up front than the cost of the risk retention interest it is required to retain.
 - If a sponsor structures a securitization to monetize excess spread on the underlying assets—which is typically effected through the sale of interest-only tranches or premium bonds—the proposed rule would “capture” the premium or

⁴ “Excess spread” is the difference between the gross yield on the pool of securitized assets less the cost of financing those assets (weighted average coupon paid on the investor certificates), charge-offs, servicing costs, and any other trust expenses (such as insurance premiums, if any).

purchase price received on the sale of the tranches that monetize the excess spread and require that the sponsor place such amounts into a separate “premium capture cash reserve account” in the securitization.

- The amount placed into the premium capture cash reserve account would be separate from and in addition to the sponsor’s base risk retention requirement under the proposal’s menu of options, and would be used to cover losses on the underlying assets before such losses were allocated to any other interest or account.

3. B-Piece Buyers in CMBS transactions.

- As contemplated by section 15G, the agencies propose to permit, for certain securitizations of commercial mortgage-backed securities (CMBS), a form of horizontal risk retention in which the horizontal first-loss position initially is held by a third-party purchaser (known as a “B-piece buyer”) that specifically negotiates for the purchase of the first-loss position and conducts its own credit analysis of each commercial loan backing the CMBS.
 - Since B-piece buyers also typically serve as the special servicer of troubled assets in the pool, investors have sometimes complained that they manipulate their servicing powers to benefit the residual interest they hold (offsetting the consequences of poor underwriting for the first-loss piece) To address this concern, the agencies are proposing to require appointment of an independent Operating Advisor to oversee servicing.

4. Prohibition Against Hedging or Transferring Required Risk Retention

- As a general matter, the proposed rule prohibits a securitizer from hedging its required retained interest or transferring it, unless to a consolidated affiliate.
 - The rule would permit hedging of interest rate or foreign exchange risk; pledging of the required retained interest on a full recourse basis; and hedging based on an index of instruments that includes the asset-backed securities, subject to limitations on the portion of the index represented by the specific securitization transaction or applicable issuing entities.

D. Disclosure Requirements

- The proposed rule also includes disclosure requirements specifically tailored to each of the permissible forms of risk retention. The disclosure requirements are designed to provide investors with material information concerning the securitizer’s retained interests, such as the amount and form of the interest retained, and the assumptions used in determining the aggregate value of ABS to be issued (which generally affects the

amount of risk required to be retained). Further, the disclosures are designed to provide investors and the agencies with an efficient mechanism to monitor compliance.

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