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# Structured Finance Alert

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## Proposed Rule to Implement Dodd-Frank Risk Retention Requirement

## EXECUTIVE SUMMARY

### Overview

On August 28, 2013, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System (**Federal Reserve Board**), the Federal Deposit Insurance Corporation (**FDIC**), the U.S. Securities and Exchange Commission (**SEC**), the Federal Housing Finance Agency (**FHFA**) and the Department of Housing and Urban Development (**HUD**) (collectively, **Agencies**) released a revised proposed rule (**Proposed Rule**) to implement the risk retention requirement of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (**Dodd-Frank Act**). The Proposed Rule follows an initial rule proposal released in April 2011 (the **Original Proposal**). The Proposed Rule reflects comments received on the Original Proposal and re-proposes the risk retention rules with a number of significant modifications. The Proposed Rule can be found here. Comments to the Proposed Rule must be received by October 30, 2013.

The risk retention requirements of Section 941 of the Dodd-Frank Act are intended to align the interests of securitizers with those of other securitization transaction participants by requiring securitizers to retain some of the credit risk in the assets they securitize, or to have "skin in the game." Section 941 added Section 15G to the Securities Exchange Act of 1934, as amended (**Exchange Act**), which requires the Agencies to prescribe risk retention rules. Section 15G generally requires a securitizer to retain no less than 5 percent of the credit risk in assets it sells into a securitization and prohibits a securitizer from directly or indirectly hedging or otherwise transferring the retained credit risk. The commentary to the Proposed Rule notes that Section 15G does not distinguish between transactions that are required to be registered with the SEC and those that are exempt from registration and the Proposed Rule applies to both public and private asset-backed securities (**ABS**) transactions.

The Proposed Rule includes alternative permissible forms for the economic interest required to be retained, provisions for the application of the rules to specific types of securitization transactions, exemptions from the standard 5 percent risk retention requirement and reduced retention requirements for securitizations of certain qualifying types of loans, most notably qualified residential mortgages. The Proposed Rule permits a sponsor to retain any combination of horizontal and/or vertical economic interest in a securitization transaction, provided that those interests generally equal at least 5 percent of the "fair value" of the securitization transaction in the aggregate. The Proposed Rule also includes a "menu of options" for permissible forms of risk retention that purports to take into account transaction-specific features of securitization transactions involving revolving master trusts, asset-backed commercial paper (**ABCP**) conduits, commercial mortgage-backed securities (**CMBS**), open market collateralized loan obligations (**CLOs**), mortgage-backed securities issued and guaranteed by government-sponsored enterprises (**GSEs**) and municipal bond repackaging securitizations.

While the Proposed Rule addresses many of the comments and concerns raised with respect to the Original Proposal, there are significant issues that have carried over from the Original Proposal and new concerns introduced by the revisions in the Proposed Rule. In general, while the commentary indicates that the Proposed Rule is intended to accommodate prudent features of existing market structures, it is highly prescriptive and would not give credit for many commonly used forms of risk retention.

We have highlighted some of the key provisions of the Proposed Rule and related issues and concerns below. The sections that follow provide a detailed description of the Proposed Rule.

## Highlights

- **Retention Based on Fair Value.** The Proposed Rule permits risk to be retained in the form of a vertical interest in each class of ABS interests issued or in a horizontal, first-loss position but requires the measurement of that interest to be based on the "fair value" of the retained interest relative to the "fair value" of all ABS interests determined in accordance with U.S. generally accepted accounting principles (**GAAP**). The Agencies acknowledge that fair value is susceptible to yielding a range of results and the Proposed Rule requires disclosure of the key inputs and assumptions used in measuring fair value. Industry participants have expressed concern about sharing proprietary valuation models and assumptions and taking responsibility in disclosure for what is effectively the expression of an opinion. Further, restrictions on the allocation of cash flows to eligible horizontal residual interests while more senior interests are outstanding conflict with features that are standard for some asset classes.
- **Flexibility in Structuring Risk Retention But Significant Conditions Have Been Added for Horizontal Interests.** The Proposed Rule provides flexibility for a sponsor to hold any combination of an eligible horizontal residual interest and a vertical interest that together meet the 5 percent risk retention requirement. The Original Proposal limited the options to an all-horizontal interest, an all-vertical interest or an equal split of horizontal and vertical interests. The Proposed Rule, however, does not give credit for some commonly used forms of risk retention. For example, subordinated notes which receive interest before principal is paid on more senior notes would not seem to qualify as an eligible form of horizontal risk retention. The provision of the Proposed Rule that requires upfront projections of future cash flow and provides that the eligible horizontal retained interest must not receive distributions (measured as a percentage of "fair value") faster than the other ABS interests receive principal (measured as a percentage of par) on any payment date, as well as the basic mismatch of the two different measures, raises multiple concerns with typical residual interests, subordinated notes with higher coupons and any subordinated note receiving interest payments prior to the commencement of principal payments as is typical in revolving structures. In addition, the use and disclosure of projections raises proprietary information and liability issues.
- **QRM Definition.** ABS that are collateralized solely by "qualified residential mortgages" or QRMs are not subject to a risk retention requirement. The Proposed Rule defines QRMs by reference to the Consumer Financial Protection Bureau's definition of a "Qualified Mortgage" or QM. Under the Dodd-Frank Act the Agencies were required to define QRM to be no broader than the definition of QM, so the QRM definition in the Proposed Rule is as broad as it can be. The Proposed Rule also requests feedback on an alternative approach that would adopt the criteria of the QM definition but add additional requirements, including an LTV of no greater than 70 percent.
- **Qualifying Asset Requirements.** While the QRM definition in the Proposed Rule is significantly less restrictive than in the Original Proposal, the definitions of "qualifying commercial loans," "qualifying commercial real estate loans" and "qualifying automobile loans" continue to reflect nonmarket terms and therefore seem to be of little utility. For example, very few if any automobile loan securitizers originate loans that would constitute "qualifying automobile loans." The Proposed Rule introduces

the concept of "blended pools" that allows qualifying loans to be securitized in the same pool with nonqualifying loans of the same asset class and permits a reduced required risk retention percentage as low as 2.5 percent.

- **Premium Capture Cash Reserve Account.** The Proposed Rule removed the requirement, included in the Original Proposal, to establish an account to capture the premium received by a securitizer on the sale of any tranches that monetize the excess spread in a securitization transaction and to retain such amounts and apply them to cover losses.

- **Representative Sample.** The Proposed Rule removes the option to hold a representative sample of assets equivalent to the assets being securitized. A representative sample option has been used by securitizers to satisfy risk retention requirements under the FDIC legal isolation safe harbor and European risk retention rules. The risk retention option in the Original Proposal required the assets to be randomly selected yet representative of the securitized pool and was criticized by commenters for being impractical to implement. The Agencies neither included the option nor have they incorporated a provision that would allow retention in the form of a participation interest in an asset pool that was suggested by commenters as a practical alternative to the Original Proposal's overly complex representative sample option.

- **Seller's Interest Option for Revolving Master Trusts.** The Proposed Rule includes a specific retention option for revolving master trust transactions such as credit card securitizations. Unfortunately the Proposed Rule defines a seller's interest in a way that does not work for most master trust transactions. It requires the allocation of collections to the seller's interest to be *pari passu* with the allocation to each series of investor ABS interests prior to the occurrence of an early amortization event, while master trusts generally allocate principal collections disproportionately in favor of investor ABS interests during any amortization or accumulation period, including a scheduled controlled amortization period. The Proposed Rule has helpful modifications allowing nonrevolving assets and giving credit for a seller's interest held at a legacy trust that issues a collateral certificate to the issuing entity. The Proposed Rule also includes provisions allowing the 5 percent seller's interest to be offset by amounts held in an excess funding account or by an eligible horizontal residual interest in each series of ABS interest or a specialized horizontal interest that could give credit for residual interest in excess spread, though there are technical problems with respect to each of these offsetting provisions that would make them of limited utility.

- **Open Market Collateralized Loan Obligations.** The Proposed Rule introduces a totally new manner of satisfying the risk retention requirements for CLOs conditioned upon the CLO acquiring only loans that are in CLO-eligible loan tranches, which are term loans in a tranche of a syndicated credit facility a minimum of 5 percent of which tranche is retained by the lead arranger of the facility. The lead arranger must also have taken at least 20 percent of the aggregate principal balance of the facility at the time of origination with no other member of the syndication group taking a greater allocation. This new proposal was apparently not requested or vetted by bank lenders; thus its practicality remains to be determined. In addition, the Agencies confirmed their view that a CLO manager is a "securitizer" and "sponsor" for risk retention rule purposes.

- **Sale and Hedging Restrictions.** The Proposed Rule generally prohibits the sale or transfer of a retained interest except to a majority-owned affiliate of the sponsor. In addition, hedging activity, except with respect to interest rate or foreign exchange risk, or through investment in an ABS indexed instrument, is generally prohibited. The Proposed Rule adds sunset provisions for these transfer and hedging prohibitions in certain circumstances.

- **Eligible ABCP Conduits.** The Proposed Rule includes a specific risk retention option for asset-backed commercial paper conduits that imposes many conditions that, if met, would exempt the conduit from retaining 5 percent of the commercial paper that it issues. As with many of the other exemptions offered in the Proposed Rule, the Agencies have layered on more conditions than any ABCP conduit in the real world likely would satisfy. Among others, a liquidity provider must provide 100 percent liquidity coverage that is also 100 percent credit enhancement. But that alone does not satisfy the eligible ABCP conduit requirements. The ABCP conduit must be collateralized solely by ABS issued by qualifying special purpose vehicles (**SPVs**) that satisfy their own risk retention requirements. Note that the application of risk retention rules to issuers of commercial paper indicates an expansive view of the definition of "asset-backed securities" by the Agencies.

- **Municipal Bond Repackaging Transactions.** The Proposed Rule adds risk retention provisions specific to issuers of tender option bonds or TOBs that constitute "qualifying tender option bond entities." The Proposed Rule provides relief for such entities if the entity retains interests that meet the requirements of an eligible horizontal interest originally but, upon the occurrence of a termination event, meet the requirements for an eligible vertical interest, or if the sponsor holds municipal securities from the same issuance equal to at least 5 percent of the securities deposited in the issuing entity.

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## GENERAL DEFINITIONS AND SCOPE

The Proposed Rule applies to any public or private ABS transaction. The Proposed Rule uses the definition of asset-backed securities in Section 3(a)(79) of the Exchange Act, which provides in relevant part that an asset-backed security is "a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset."[1]

The Proposed Rule defines an "**ABS interest**" as any type of interest or obligation issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest or residual interest, payments on which are primarily dependent on the cash flows of the collateral owned or held by the issuing entity.[2]

The Proposed Rule generally imposes the retention requirement on a "**sponsor**," which it defines 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.

In some circumstances a portion of the risk retention may be held by an "**originator**," which the Proposed Rule defines as a person who (i) through an extension of credit, creates an asset that collateralizes an asset-backed security and (ii) sells the asset directly or indirectly to a securitizer or issuing entity.

## GENERAL RISK RETENTION REQUIREMENT

### Minimum Risk Retention Requirement

The Proposed Rule generally requires a sponsor (or its majority-owned affiliate) to retain an economic interest equal to at least 5 percent of the aggregate credit risk of the assets collateralizing an issuance of ABS.[3] The standard forms of risk retention are an eligible horizontal residual interest or an eligible vertical interest in the issued ABS, or a combination of the two. The Proposed Rule also includes asset-specific risk retention options intended to accommodate different asset-specific transaction structures that have developed in the market. Generally, the holder of any interest retained to comply with the risk retention requirements may not hedge the retained interest and must hold the retained interest until a sunset date, if applicable.

### Permissible Forms of Risk Retention — Menu of Options

#### Standard Risk Retention

Under the standard risk retention option of the Proposed Rule, a sponsor, or its majority-owned affiliate, may meet the risk retention requirement by retaining interests in the form of an eligible vertical interest (which would be an interest in every class of ABS interest and may be held in the form of a single security), an eligible horizontal residual interest (or cash reserve account, which would be the most subordinate interest) or any combination thereof. The interest the sponsor is required to retain must have a fair value of no less than 5 percent of the fair value of all ABS interests in the issuing entity issued as part of the securitization transaction, determined on the pricing date in accordance with GAAP.

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[1] 15 U.S.C. 78c(a)(79).

[2] The **ABS interest** definition does not include common or preferred stock, limited liability interests, partnership interests, trust certificates or similar interests that (i) are issued primarily to evidence ownership of the issuing entity and (ii) the payments, if any, on which are not primarily dependent on the cash flows of the collateral held by the issuing entity. The definition also does not include the right to receive payments for services provided by the holder of such right, including servicing, trustee services and custodial services.

[3] If there is more than one sponsor, each sponsor must ensure that at least one of the sponsors (or at least one of their majority-owned affiliates) retains an economic interest in the credit risk of the securitized assets that satisfies the requirements of the Proposed Rule.

**Horizontal Risk Retention.** The sponsor of a securitization transaction may satisfy the risk retention requirements by retaining an "eligible horizontal residual interest," which may be held as an interest in a single class or multiple classes, provided that each interest, individually or in the aggregate, qualifies as an eligible horizontal residual interest. The Proposed Rule defines "**eligible horizontal residual interest**" as an ABS interest in the issuing entity:

- with respect to which, on any payment date on which the issuing entity has insufficient funds to satisfy its obligation to pay all contractual interest or principal due, any resulting shortfall will reduce amounts paid to the eligible horizontal residual interest prior to any reduction in the amounts paid to any other ABS interest, whether through loss allocation, operation of the priority of payments, or any other governing contractual provision and
- that has the most subordinated claim to payments of both principal and interest by the issuing entity.

In lieu of retaining all or part of an eligible horizontal residual interest, the sponsor may fund a cash reserve account to be maintained by a trustee in an amount equal to the eligible horizontal residual interest otherwise required to be held. Amounts in the account may be invested only in:

- United States Treasury securities with maturities of one year or less,
- deposits in one or more insured depository institutions (as defined in Section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)) that are fully insured by federal deposit insurance or
- with respect to securitization transactions in which the ABS interests or the securitized assets are denominated in a currency other than U.S. dollars, sovereign bonds denominated in such other currency with maturities of one year or less or fully insured deposit accounts denominated in such other foreign currency and held in a foreign bank whose home country supervisor has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision (as amended).

Until all ABS interests in the issuing entity are paid in full, or the issuing entity is dissolved, amounts in the horizontal cash reserve account must be released to satisfy payments on ABS interests in the issuing entity on any payment date on which the issuing entity has insufficient funds from any source to satisfy an amount due on any ABS interest. No amounts, other than investment earnings, may be withdrawn or distributed from the account unless the conditions described in the paragraph below are met.

A sponsor retaining any eligible horizontal residual interest or funding a horizontal cash reserve account must perform calculations showing that the projected rate at which cash flow is expected to be paid to the holder of the eligible horizontal residual interest will not exceed the rate at which principal payments are expected to be made to all ABS interest holders. Prior to the issuance of the eligible horizontal residual interest or funding of a horizontal cash reserve account (and at the time of any subsequent issuance of ABS interests), the sponsor must calculate the "Closing Date Projected Cash Flow Rate" and the "Closing Date Projected Principal Repayment Rate" for each payment date. The sponsor must certify to investors that the Closing Date Projected Cash Flow Rate for each payment date does not exceed the Closing Date Projected Principal Repayment Rate for such payment date. In calculating the fair value of cash flows, the amount of cash flow so projected to be paid and the projected principal repayments, the issuing entity must use the same assumptions and discount rates as were used in determining the fair value of the ABS interests in the transaction (or the amount that must be placed in an eligible horizontal cash reserve account, equal to the fair value of an eligible horizontal residual interest).

The "**Closing Date Projected Cash Flow Rate**" for any payment date is the percentage obtained by dividing:

- the fair value of all cash flow projected, as of the securitization closing date, to be paid to the holder of the eligible horizontal residual interest (or, if a horizontal cash reserve account is established, released to the sponsor or other holder of such account), through such payment date (including cash flow projected to be paid to such holder on such payment date) by

- the fair value of all cash flow projected, as of the securitization closing date, to be paid to the holder of the eligible horizontal residual interest (or, with respect to any horizontal cash reserve account, released to the sponsor or other holder of such account), through the maturity of the eligible horizontal residual interest (or the termination of the horizontal cash reserve account).

The "**Closing Date Projected Principal Repayment Rate**" for any payment date is the percentage obtained by dividing:

- the amount of principal projected, as of the securitization closing date, to be paid on all ABS interests through such payment date (or released from the horizontal cash reserve account to the sponsor or other holder of such account), including principal payments projected to be paid on such payment date by
- the aggregate principal amount of all ABS interests issued in the transaction.

**Alternative Eligible Horizontal Residual Interest Proposal.** The Agencies also are seeking input on an alternative approach relating to the amount of principal that may be distributed on an eligible horizontal residual interest. Under this approach, on any payment date, the cumulative amount paid to the holder of an eligible horizontal residual interest may not exceed a proportionate share of the cumulative amount paid to all holders of ABS interests.[4] The proportionate share is determined by dividing the fair value of the eligible horizontal residual interest by the fair value of all of the ABS interests issued in the transaction, in each case measured on the issuance date. The commentary to the Proposed Rule notes that any excess amounts not permitted to be distributed to the holder of the eligible horizontal residual interest could be paid to more senior classes, placed into a reserve account, or allocated in any other manner that does not result in payments to the holder of the retained interest exceeding the permitted amount.

**Vertical Risk Retention.** Under the Proposed Rule, a sponsor may satisfy the 5 percent risk retention requirement by retaining an "**eligible vertical interest**," defined as either (i) a single vertical security or (ii) an interest in each class of ABS interests in the issuing entity issued as part of the securitization transaction that constitutes the same portion of the fair value of each such class. "**Single vertical security**" is defined as an ABS interest entitling the sponsor to specified percentages of the principal and interest paid on each class of ABS interests in the issuing entity (other than such single vertical security), which specified percentages result in the fair value of each interest in each such class being identical. The single vertical security option permits a sponsor to hold a single security rather than multiple securities.

**Disclosure.** A sponsor must provide certain information to potential investors a reasonable period of time prior to the sale of the ABS and, upon request, to the SEC and its appropriate Federal banking agency, if any, until three years after all ABS interests are no longer outstanding. This information includes in all cases:

- a description of the methodology used to calculate the fair value of all classes of ABS interests;
- the key inputs and assumptions used in measuring the total fair value of all classes of ABS interests and the fair value of the eligible horizontal residual interest retained by the sponsor, including quantitative information about discount rates, loss given default (recovery), prepayment rates, defaults, lag time between default and recovery and the basis of forward interest rates used, as applicable; and
- the reference data set or other historical information used to develop these key inputs and assumptions, including loss given default and actual defaults.

For an eligible horizontal residual interest the information also includes:

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[4] For purposes of this calculation, all amounts paid to ABS holders would be included, including principal repayment, interest payments, excess spread and residual payments. Fees and expenses paid to service providers would not be included.

- the fair value of the eligible horizontal residual interest the sponsor will retain or did retain (or the amount the sponsor placed in the horizontal cash reserve account) at the closing of the securitization transaction and the fair value of the eligible horizontal residual interest that the sponsor is required to retain (or to fund through the horizontal cash reserve account);[5]
- a description of the material terms of the eligible horizontal residual interest and/or the horizontal cash reserve account; and
- as of a disclosed date that is no more than 60 days prior to the closing date, the number of securitization transactions securitized by the sponsor during the previous five-year period in which the sponsor retained an eligible horizontal residual interest, and the number (if any) of payment dates in each such securitization on which actual payments to the sponsor with respect to the eligible horizontal residual interest exceeded the cash flow projected to be paid to the sponsor on such payment date in determining the Closing Date Projected Cash Flow Rate.

For a vertical interest the information also includes whether the sponsor will retain (or did retain) the eligible vertical interest as a single vertical security or as a separate proportional interest in each class of ABS interests. Where an eligible vertical interest is retained as a single vertical security, the sponsor must disclose the fair value amount of the single vertical security that the sponsor (i) will retain (or did retain) at the closing of the securitization transaction and (ii) is required to retain, as well as each class of ABS interests in the issuing entity underlying the single vertical security at the closing of the securitization transaction and the percentage of each class of ABS interests in the issuing entity that the sponsor would have been required to retain if the sponsor held the eligible vertical interest as a separate proportional interest in each class of ABS interest in the issuing entity. Where an eligible vertical interest is retained as a separate proportional interest in each class of ABS interests, the sponsor must disclose the percentage of each class of ABS interests in the issuing entity that the sponsor will retain (or did retain) at the closing of the securitization transaction and the percentage of each class of ABS interests in the issuing entity that the sponsor is required to retain.

### Revolving Master Trusts

The Proposed Rule provides a specific risk retention option for securitizations collateralized by assets held in a revolving master trust.[6] In general, under the Proposed Rule the sponsor of a revolving master trust securitization satisfies the risk retention requirement by retaining a seller's interest representing at least 5 percent of the unpaid principal balance of all outstanding ABS interests held by investors in the issuing entity.[7] The Proposed Rule uses the principal balance rather than the fair value of outstanding ABS interests for this test. The 5 percent test must be met at the closing of each issuance by the revolving master trust and at every seller's interest measurement date specified under the securitization transaction documents (not less than monthly), until no ABS interest in the issuing entity is held by any person not affiliated with the sponsor. The seller's interest also may be combined with either a standard eligible horizontal residual interest or a special horizontal interest applicable only to revolving master trusts that meets the conditions described below.

**Seller's Interest.** A "**seller's interest**" is an ABS interest:

- collateralized by all of the securitized assets and servicing assets[8] owned or held by the issuing entity other than assets that have been allocated as collateral only for a specific series;

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[5] The fair value is expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS are issued, as applicable).

[6] A revolving master trust is a trust established to issue ABS on multiple issuance dates collateralized by a common pool of securitized assets that will change in composition over time.

[7] The seller's interest can be held by the sponsor or by one or more wholly owned affiliates of the sponsor, including one or more depositors of assets into the revolving master trust.

[8] "**Servicing assets**" are rights or other assets designed to assure the timely distribution of proceeds to ABS interest holders and assets that are related or incidental to purchasing or otherwise acquiring and holding the issuing entity's securitized assets. Servicing assets include amounts received by the issuing entity as proceeds of rights or other assets, whether as remittances by obligors or as other recoveries.

- that is *pari passu* to each series of investors' ABS interests issued with respect to the allocation of all distributions and losses with respect to the securitized assets prior to an early amortization event; and
- that adjusts for fluctuations in the outstanding principal balance of the securitized assets in the pool.

Significantly, the *pari passu* requirement is inconsistent with the allocation methodology of most revolving master trusts that allocate principal disproportionately in favor of investor ABS interests during any amortization period and not just following an early amortization event.

**Multilevel Trusts.** If one revolving master trust issues a collateral certificate representing a beneficial interest in all or a portion of the securitized assets held by that trust to another revolving trust, which in turn issues ABS interests for which the collateral certificate represents all or a portion of the securitized assets, a sponsor may satisfy the risk retention requirement by retaining the seller's interest for the assets represented by the collateral certificate through either revolving master trust, so long as both revolving master trusts are maintained at the direction of the same sponsor or its wholly-owned affiliates. If the sponsor retains the seller's interest associated with the collateral certificate at the level of the revolving trust that issues the collateral certificate, the proportion of the seller's interest that must be retained at that level must be no less than the proportion that the securitized assets represented by the collateral certificate bears to the total securitized assets in the revolving master trust that issues the ABS interests, as of each measurement date.

**Offset for Pool-Level Excess Funding Account.** The 5 percent seller's interest required on each measurement date may be reduced on a dollar-for-dollar basis by the balance of an excess funding account as of such date. The excess funding account must be a segregated account that:

- is funded in the event of a failure to meet the minimum seller's interest requirements by distributions otherwise payable to the holder of the seller's interest;
- is *pari passu* to each series of investors' ABS interests with respect to the allocation of losses prior to an early amortization event; and
- in the event of an early amortization, makes payments of amounts held in the account to holders of investors' ABS interests in the same manner as distributions on securitized assets.

**Combined Retention With Horizontal Interest.** The seller's interest retention requirement may be reduced to a percentage lower than 5 percent to the extent that, for all series of ABS interests issued by the revolving master trust, the sponsor or wholly-owned affiliate of the sponsor retains a corresponding percentage of the fair value of all ABS interests issued in each series held in the form of (i) an eligible horizontal residual interest meeting the standard requirements or (ii) a horizontal interest meeting the following requirements:

- each series distinguishes between the series' share of the interest and fee cash flows and the series' share of the principal repayment cash flows from the securitized assets;
- the horizontal interest's claim to any of the series' share of the interest and fee cash flows for any interest payment period is subordinated to all accrued and payable interest and principal due on the payment date to more senior ABS interests in the series for that period, and further reduced by the series' share of losses, including defaults on principal of the securitized assets collateralizing the revolving master trust for that period, to the extent that such payments would have been included in amounts payable to more senior interests in the series; and
- the horizontal interest has the most subordinated claim to any part of the series' share of principal repayment cash flows.

The horizontal interest may be certificated or uncertificated and held in a single or multiple classes, subclasses or tranches, so long as it meets, individually or in the aggregate, the requirements described above.

**Early Amortization of All Outstanding Series.** Under the Proposed Rule, if a sponsor's seller's interest falls below the required amount after an event of default triggers early amortization of all series of ABS interests issued by the trust to persons not affiliated with the sponsor, such a decline does not violate the rule's risk retention requirements, provided that each of the following four requirements are met:

- the sponsor was in full compliance with the risk retention requirements on all measurement dates before the early amortization trigger occurred;
- the terms of the seller's interest continue to make it *pari passu* or subordinate to each series of investors' ABS interests with respect to the allocation of losses;
- the terms of any horizontal interest the sponsor is relying upon to offset the minimum seller's interest amount continue to require the interests to absorb losses; and
- the revolving master trust issues no additional ABS interests after early amortization is initiated to any person not affiliated with the sponsor, either during the amortization period or at any time thereafter.

**Disclosure.** A sponsor must provide certain information to potential investors a reasonable period of time prior to the sale of the ABS and, upon request, to the SEC and its appropriate Federal banking agency, if any. This information includes:

- (a) the value of the seller's interest that the sponsor will retain (or did retain) at the closing of the securitization transaction, (b) the fair value of any horizontal risk retention that the sponsor will retain (or did retain) at the closing of the securitization transaction and (c) the unpaid principal balance or fair value, as applicable, that the sponsor is required to retain;
- a description of the material terms of the seller's interest and of any horizontal risk retention; and
- if the sponsor will retain (or did retain) any horizontal risk retention, the same information as is required to be disclosed by sponsors retaining horizontal interests.

## Representative Sample

The Original Proposal included in the menu of options for permissible risk retention a randomly selected representative sample of assets equal to at least 5 percent of the unpaid principal balance of all pool assets initially identified for securitizing that would be equivalent in all material respects to the securitized assets. This option has been removed from the Proposed Rule. The Agencies concluded that this option would be difficult to implement and the costs of utilization might outweigh its benefits.

## Asset-Backed Commercial Paper Conduits

The Proposed Rule contains a risk retention option for eligible ABCP structures. Under the Proposed Rule, an ABCP conduit sponsor satisfies the risk retention requirement where the ABCP is issued by an eligible ABCP conduit and, for each ABS interest the ABCP conduit acquires from an intermediate SPV, the intermediate SPV's originator-seller retains an economic interest in the credit risk of the assets collateralizing the ABS interest.[9] The risk retained by the originator-seller must be in the same form, amount and manner as the sponsor would be required to retain under the standard risk retention option or the master trust risk retention option, if applicable.

**Eligible ABCP Conduit.** An eligible ABCP conduit is an ABCP conduit that meets the following conditions:

- the ABCP conduit is bankruptcy-remote or otherwise isolated for insolvency purposes from the sponsor of the ABCP conduit and from any intermediate SPV.

[9] "**Originator-seller**" means an entity that originates assets and sells or transfers those assets directly, or through a majority-owned OS affiliate, to an intermediate SPV. "**Majority-owned OS affiliate**" means an entity that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, an originator-seller participating in an eligible ABCP conduit. "**Majority control**" means ownership of more than 50 percent of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under GAAP.

- the ABCP conduit must acquire the ABS that collateralize the ABCP conduit in an initial issuance by or on behalf of an intermediate SPV (i) directly from the intermediate SPV, (ii) from an underwriter of the securities issued by the intermediate SPV or (iii) from another person who acquired the securities directly from the intermediate SPV.
- the ABS acquired by the eligible ABCP conduit must be collateralized solely by:
  - ABS collateralized solely by assets originated by an originator-seller or one or more majority-owned OS affiliates of the originator-seller and by servicing assets;
  - special units of beneficial interest or similar interests in a trust or special purpose vehicle that retains legal title to leased property underlying leases that were transferred to an intermediate SPV in connection with a securitization collateralized solely by such leases originated by an originator-seller or majority-owned OS affiliate and by servicing assets; or
  - interests in a revolving master trust collateralized solely by assets originated by an originator-seller or majority-owned OS affiliate and by servicing assets.
- the ABS acquired by the eligible ABCP conduit may not be collateralized by ABS otherwise purchased or acquired by the intermediate SPV, the intermediate SPV's originator-seller or a majority-owned OS affiliate of the originator-seller.
- the ABCP conduit is collateralized solely by ABS that meet the criteria described above and by servicing assets.
- a regulated liquidity provider[10] must have entered into a legally binding commitment to provide 100 percent liquidity coverage[11] to all the ABCP issued by the ABCP conduit if funds are required to repay any maturing ABCP.

**ABCP Maturity.** The ABCP must have a maturity at the time of issuance of no more than nine months (exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited).

**Intermediate SPV.** To qualify as an intermediate SPV, a special purpose vehicle must:

- be a direct or indirect wholly owned affiliate of the originator-seller;
- be bankruptcy-remote or otherwise isolated for insolvency purposes from the eligible ABCP conduit, the originator-seller and any majority-owned OS affiliate that, directly or indirectly, sells or transfers assets to such intermediate SPV;
- acquire assets that are originated by the originator-seller or its majority-owned OS affiliate from the originator-seller or majority-owned OS affiliate, or acquire ABS issued by another intermediate SPV or the original seller that are collateralized solely by such assets; and
- issue ABS collateralized solely by such assets. The commentary to the Proposed Rule notes that an intermediate SPV may sell ABS that it issues to parties other than ABCP conduits.

The commentary to the Proposed Rule also notes that a structure may include multiple intermediate SPVs. Intermediate SPVs in structures with multiple intermediate SPVs that do not issue ABS

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[10] "**Regulated liquidity provider**" means: (i) a depository institution (as defined in Section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)); (ii) a bank holding company (as defined in 12 U.S.C. 1841), or a subsidiary thereof; (iii) a savings and loan holding company (as defined in 12 U.S.C. 1467a), provided all or substantially all of the holding company's activities are permissible for a financial holding company under 12 U.S.C. 1843(k), or a subsidiary thereof; or (iv) a foreign bank whose home country supervisor (as defined in § 211.21 of the Federal Reserve Board's Regulation K (12 CFR 211.21)) has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision, as amended, and that is subject to such standards, or a subsidiary thereof.

[11] The liquidity provider is obligated to pay an amount equal to any shortfall. The total amount that may be due is 100 percent of the amount of the ABCP outstanding at any time plus accrued and unpaid interest. Amounts due pursuant to the required liquidity coverage may not be subject to credit performance of the ABS held by the ABCP conduit or reduced by the amount of credit support provided to the ABCP conduit. Liquidity support that only funds performing receivables or performing ABS interests does not satisfy the liquidity coverage requirement.

collateralized solely by ABS interests must be pass-through entities that either transfer assets to other SPVs in anticipation of securitization (*e.g.*, a depositor) or transfer ABS interests to the ABCP conduit or another intermediate SPV.

**Sponsor's Duty to Comply.** The ABCP conduit retaining sponsor is responsible for compliance with the requirements of the ABCP risk retention option and must maintain policies designed to monitor compliance by each originator-seller and any majority-owned OS affiliate that sells assets to the eligible ABCP conduit. The ABCP conduit sponsor must promptly notify the holders of the ABCP, the SEC and its appropriate federal banking agency, if any, of the name and form of organization of any originator-seller that fails to retain risk or of any originator-seller or majority-owned OS affiliate that hedges, directly or indirectly through an intermediate SPV, its risk retention and the amount of ABS issued by an intermediate SPV of such originator-seller or majority-owned OS affiliate and held by the ABCP conduit.

The ABCP conduit sponsor also must take remedial steps that may include curing any breach or removing any asset-backed security that does not comply from the eligible ABCP conduit. The commentary to the Proposed Rule notes that to cure the noncompliance of a non-conforming asset, the sponsor could purchase the nonconforming asset from the ABCP conduit, purchase 5 percent of the outstanding ABCP and comply with the vertical risk retention requirements or declare an event of default and accelerate the repayment of the underlying assets (provided such remedy is permitted under the transaction documents). The ABCP conduit sponsor must notify the holders of the ABCP, the SEC and its appropriate federal banking agency, if any, of any remedial actions taken.

**Originator-Seller Compliance With Risk Retention.** The use of the ABCP risk retention option by an ABCP conduit sponsor does not relieve the originator-seller that sponsors ABS interests acquired by an eligible ABCP conduit from such originator-seller's independent obligation, if any, to comply with its own risk retention obligations. The commentary to the Proposed Rule notes that where an originator-seller is the sponsor of the ABS issued by an intermediate SPV, it is required to hold an economic interest in the credit risk of the assets collateralizing the ABS issued by the intermediate SPV.

**Disclosure.** The ABCP conduit sponsor must provide certain information to each purchaser of ABCP, before or at the time of the first sale of ABCP to such purchaser. In addition, at least monthly thereafter, the ABCP conduit sponsor must provide certain information to each holder of ABCP. This information includes:

- the name and form of organization of the regulated liquidity provider (including a description of the form, amount and nature of such liquidity coverage, and notice of any failure to fund); and
- with respect to each ABS interest held by the ABCP conduit: (a) the asset class or brief description of the underlying receivables; (b) the standard industrial classification category code for the originator-seller or majority-owned OS affiliate that will retain or has retained an interest in the securitization transaction; and (c) a description of the form, fair value, as applicable, and nature of such interest.

Upon request, an ABCP conduit sponsor also must provide this information to the SEC and its appropriate Federal banking agency, if any, as well as the name and form of organization of each originator-seller or majority-owned OS affiliate that will retain or has retained an interest in the securitization transaction.

## Commercial Mortgage-Backed Securities

The Proposed Rule provides a specific method of risk retention for commercial mortgage loan securitizations. Under the CMBS option, a sponsor may satisfy some or all of its risk retention requirements if a third party purchases and holds for its own account an eligible horizontal residual interest in the issuing entity in the same form, amount and manner as the sponsor would be required to hold under the standard risk retention option. To comply with the CMBS option, the following conditions must be met:

**Number of Third-Party Purchasers.** There may be no more than two third-party purchasers. If there are two third-party purchasers, they must be *pari passu*.

**Composition of Collateral.** The securitization transaction may be collateralized only by commercial real estate loans and servicing assets.

**Source of Funds.** Each third-party purchaser must pay for the eligible horizontal residual interest in cash at the closing of the securitization transaction. No third-party purchaser may obtain financing, directly or indirectly, for the purchase of such interest from any other person that is a party to, or an affiliate of a party to, the securitization transaction (other than a special servicer[12] affiliated with the third-party purchaser or an investor that is a party to the transaction solely as an investor).

**Third-Party Review.** Each third-party purchaser must conduct an independent review of the credit risk of each securitized asset prior to the sale of the ABS. This review must include a review of the underwriting standards, collateral and expected cash flows of each commercial real estate loan that is collateral for the ABS.

**Affiliation and Control Rights.** No third-party purchaser may be affiliated with any party to the securitization transaction other than (i) investors, (ii) the special servicer and (iii) one or more originators of the securitized assets, provided that the assets originated by such originators collectively comprise less than 10 percent of the unpaid principal balance of the securitized assets at closing of the securitization transaction. There is no prohibition on third-party purchasers having control rights related to servicing.

**Operating Advisor.** An "**Operating Advisor**" must be appointed act in the best interest of, and for the benefit of, investors as a collective whole. The Operating Advisor may not be affiliated with other parties to the securitization transaction and may not have, directly or indirectly, any financial interest in the securitization transaction (other than in fees from its role as Operating Advisor).

The Operating Advisor is responsible for reviewing the actions of the special servicer. When the eligible horizontal residual interest has a principal balance of 25 percent or less of its initial principal balance, the special servicer must consult with the Operating Advisor before making any material decision in connection with its servicing of the securitized assets. The Operating Advisor must issue periodic reports to investors and the issuing entity concerning whether the Operating Advisor believes that the special servicer is operating in compliance with the standards required of the special servicer in the transaction documents.

If the Operating Advisor determines, in its sole discretion exercised in good faith, that the special servicer has failed to comply with a standard required of the special servicer and that a replacement of the special servicer would be in the best interest of the investors as a collective whole, the Operating Advisor may recommend that the special servicer be replaced. The special servicer will be replaced upon such a recommendation and the affirmative vote of a majority of the outstanding principal balance of all ABS interests voting on the matter.[13]

**Disclosure.** The sponsor is required to provide certain information to potential investors and, upon request, to the SEC and its appropriate federal banking agency. This information includes:

- the name and form of organization of each initial third-party purchaser;
- a description of each initial third-party purchaser's experience in investing in CMBS;
- the purchase price paid by each initial third-party purchaser;

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[12] "**Special servicer**" is defined to mean, with respect to any securitization of commercial real estate loans, any servicer that, upon the occurrence of one or more specified conditions in the servicing agreement, has the right to service one or more assets in the transaction.

[13] The holders of at least 5 percent of the outstanding principal balance of all ABS interests in the issuing entity must vote on the replacement of the special servicer.

- a description of the material terms of the eligible horizontal residual interest retained by each initial third-party purchaser;
- a description of the fair value of the eligible horizontal residual interest that will be retained (or was retained) by each initial third-party purchaser and the fair value of the eligible horizontal residual interest in the securitization transaction that the sponsor would have retained pursuant to the standard risk retention option if the sponsor had relied on that option and retained an eligible horizontal residual interest;
- the material terms of the transaction documents relating to the Operating Advisor (including the name and form of organization of the Operating Advisor, the terms of the Operating Advisor's compensation and the standards required of the Operating Advisor with respect to its experience, expertise and financial strength, as well as a description of how the Operating Advisor satisfies each of the standards);
- the representations and warranties concerning the securitized assets, a schedule of any securitized assets that do not comply with such representations and warranties, and what factors were used to make the determination that such securitized assets should nevertheless be included in the pool; and
- any other information regarding each initial third-party purchaser or each initial 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.

**Hedging, Transfer and Pledging.** For the first five years after the closing of a securitization transaction, each third-party purchaser must comply with the hedging, transfer and other restrictions of the Proposed Rules as if it were the retaining sponsor and had acquired the eligible horizontal residual interest pursuant to the standard risk retention option. However, on or after the date that is five years after the date of the closing of a securitization transaction, an initial third-party purchaser or a sponsor that acquired an eligible horizontal residual interest at the closing of a securitization transaction may transfer that interest to a subsequent third-party purchaser. A subsequent third-party purchaser may transfer its interest to a different third-party purchaser at any time. At the time of transfer, the acquiring third-party purchaser must satisfy the same criteria as an initial third-party purchaser was required to satisfy at the time the securitization transaction closed (including reviewing the credit risk of each securitized asset).

**Sponsor's Duty to Comply.** A sponsor relying on the CMBS option must maintain and adhere to policies and procedures to monitor each third-party purchaser's compliance with the requirements of the CMBS option. If the sponsor determines that a third-party purchaser no longer complies with any of these requirements, the sponsor must promptly notify the holders of the ABS interests issued in the securitization transaction of such noncompliance.

## Government-Sponsored Enterprises

Under the Proposed Rule, the guarantee provided by Fannie Mae or Freddie Mac (each an **Enterprise**) as a sponsor satisfies the risk retention requirements, provided the Enterprise is operating under the conservatorship or receivership of the FHFA with capital support from the U.S. government. Similarly, an equivalent guarantee provided by a limited-life regulated entity that succeeds to the charter of an Enterprise also satisfies the risk retention requirement if the entity operates under the authority and oversight of the FHFA with capital support from the U.S. government. An Enterprise or a successor would be required to choose a different retention option if it began to operate other than as described in the Proposed Rule. The hedging provisions described below in "Hedging, Transfer and Financing Restrictions" do not apply to (i) a sponsor relying on the Enterprise risk retention option, (ii) an affiliate of such a sponsor or (iii) the issuing entity in a securitization transaction where the sponsor relies on this risk retention option. A sponsor relying on this risk retention option must disclose to investors and, upon request, to the FHFA and the SEC, a description of the manner in which it has satisfied the credit risk retention requirements.

## Open Market Collateralized Loan Obligations

The Proposed Rule offers a separate risk retention option, in addition to the standard vertical or horizontal options, for collateralized loan obligation (**CLO**) transactions that qualify as "open market CLOs." Under this option, the 5 percent risk retention requirement may be satisfied by lead arrangers retaining at least 5 percent of the face amount of loans purchased by the CLO. For a sponsor to use this option, the following conditions must be met:

- the CLO does not acquire or hold any assets other than CLO-eligible loan tranches and servicing assets;
- the governing documents of the CLO require that, at all times, the assets of the CLO consist of senior, secured syndicated loans that are CLO-eligible loan tranches and servicing assets;
- the CLO does not invest in ABS interests or in credit derivatives other than hedging transactions that are servicing assets to hedge risks of the CLO;
- all purchases of CLO-eligible loan tranches and other assets by the CLO issuing entity or through a warehouse facility are made in open market transactions on an arms-length basis; and
- the CLO manager of the open market CLO is not entitled to receive any management fee or gain on sale at the time the CLO issues its ABS interests.

"**Open market CLO**" means a CLO (i) whose assets consist only of senior, secured syndicated loans that are acquired directly from the sellers thereof in open market transactions and of servicing assets, (ii) that is managed by a CLO manager and (iii) that holds less than 50 percent of its assets, by aggregate outstanding principal amount, in loans syndicated by lead arrangers that are affiliates of the CLO or originated by originators that are affiliates of the CLO.

"**Lead arranger**" means the institution that:

- is active in the origination, structuring and syndication of commercial loan transactions and played a primary role in the structuring, underwriting and distribution on the primary market of the CLO-eligible loan tranche;
- took an allocation of the syndicated credit facility under the terms of the transaction that includes a CLO-eligible loan tranche at least equal to the greater of 20 percent of the aggregate principal balance at origination or the largest allocation of any syndication member at origination; and
- is identified at the time of origination in the credit agreement and intercreditor documents, represents in such documents that the requirements are met for relying on this risk retention option and covenants that it will continue to retain the required percentage of the CLO-eligible loan tranche over the life of the loan.

"**CLO-eligible loan tranche**" means a term loan of a syndicated credit facility to a commercial borrower that has the following features:

- a minimum of 5 percent of the face amount of the CLO-eligible loan tranche is retained by the lead arranger until the earliest of the repayment, maturity, involuntary and unscheduled acceleration, payment default, or bankruptcy default of the CLO-eligible loan tranche, provided that the lead arranger complies with limitations on hedging, transferring and pledging described in "Hedging, Transfer and Financing Restrictions" below;
- lender voting rights in the credit agreement and any intercreditor or other applicable agreements governing the CLO-eligible loan tranche provide holders of the CLO-eligible loan tranche consent rights with respect to any material waivers and amendments of such documents, including adverse changes to money terms, alterations to *pro rata* provisions, changes to voting provisions and waivers of conditions precedent; and

- the *pro rata*, voting and similar provisions applicable to the security associated with the CLO-eligible loan tranches under the CLO credit agreement and any intercreditor or other applicable agreements governing the CLO-eligible loan tranches are not materially less advantageous to the obligor than the terms of other tranches of comparable seniority in the broader syndicated credit facility.

**Disclosure.** A sponsor relying on the open market CLO risk retention option must, a reasonable period of time prior to the sale of the ABS and at least annually with respect to the information described in the second bullet below, provide to potential investors and, upon request, to the SEC and its appropriate federal banking agency, if any:

- the full legal name and form of organization of the CLO manager; and
- a complete list of every asset held by the open market CLO (or before the CLO's closing, in a warehouse facility in anticipation of transfer into the CLO at closing), including:
  - the full legal name and standard industrial classification category code of the obligor of the loan or asset;
  - the full name of the specific loan tranche held by the CLO;
  - the face amount of the loan tranche held by the CLO;
  - the price at which the loan tranche was acquired by the CLO; and
  - for each loan tranche, the full legal name of the lead arranger.

## Municipal Bond "Repackaging" Securitizations

The Proposed Rule permits two additional risk retention options for sponsors of tender option bond (**TOB**) programs. Under the Proposed Rule, a TOB is defined as a security that (i) entitles the holders to tender their bonds to the issuing entity for purchase at any time upon no more than 30 days' notice and (ii) qualifies for purchase by money market funds under Rule 2a-7 of the Investment Company Act of 1940, as amended (**Investment Company Act**).

In order to avail itself of the additional TOB risk retention options, an issuing entity must meet the following conditions (**a Qualified Tender Option Bond Entity**):

- the issuing entity is collateralized solely by servicing assets and municipal securities[14] that have the same municipal issuer and the same underlying obligor or source of payment (determined without regard to any third-party credit enhancement), and such municipal securities are not subject to substitution;
- the issuing entity only issues two classes of securities: (i) a single class of TOBs with a preferred variable return payable out of capital and (ii) a single residual equity interest that is entitled to the remaining income of the TOB issuing entity; and both of these classes constitute "asset-backed securities" as defined in Section 3(a)(79) of the Exchange Act;
- the underlying municipal securities held as assets by the issuing entity are issued in compliance with Section 103 of the Internal Revenue Code of 1986, as amended (**Internal Revenue Code**), such that the interest payments made on those securities are excludable from the gross income of the owners;
- the holders of all of the securities issued by the issuing entity are eligible to receive interest that is excludable from gross income pursuant to Section 103 of the Internal Revenue Code or "exempt-interest dividends" pursuant to Section 852(b)(5) of the Internal Revenue Code in the case of regulated investment companies under the Investment Company Act;

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[14] The term "**municipal security**" or "**municipal securities**" has the same meaning as municipal securities in Section 3(a)(29) of the Exchange Act and any rules promulgated pursuant to such section.

- the issuing entity has a legally binding commitment from a regulated liquidity provider to provide a 100 percent guarantee or liquidity coverage with respect to all of the issuing entity's outstanding TOBs; and
- the issuing entity qualifies for monthly closing elections pursuant to IRS Revenue Procedure 2003-84.

In addition to the standard risk retention options, the sponsor of a Qualified Tender Option Bond Entity may satisfy its risk retention requirements through either of the following two additional options:

- retention of an interest that upon issuance meets the requirements of an "eligible horizontal residual interest" but that upon the occurrence of a "tender option termination event" (as defined in Section 4.01(5) of IRS Revenue Procedure 2003-84)[15] will meet the requirements of an "eligible vertical interest."
- holding municipal securities from the same issuance of municipal securities deposited in the Qualified Tender Option Bond Entity, the face value of which retained municipal securities is equal to 5 percent of the face value of the municipal securities deposited in the Qualified Tender Option Bond Entity.

The prohibitions on transfer and hedging described in "Hedging, Transfer and Financing Restrictions" below apply to any municipal securities retained by the sponsor of a TOB program that satisfies its risk retention obligations by holding municipal securities as set forth above.

The sponsor must provide to potential investors a reasonable period of time prior to the sale of the securities and, upon request, to the SEC and its appropriate federal banking agency, if any, the following disclosure: (i) the name and form of organization of the Qualified Tender Option Bond Entity and (ii) a description of the form, fair value and nature of the interest retained by the sponsor.

### Premium Capture Cash Reserve Account

Under the Original Proposal, sponsors of securitization transactions that sold premium or interest-only ABS tranches to investors would have been subject to increased risk retention requirements. To satisfy these heightened risk retention requirements, the sponsor either would have had to (i) increase its risk retention by the amount of proceeds in excess of 95 percent of the par value of ABS interests, or (ii) deposit the difference into a first-loss premium capture cash reserve account (**PCCRA**). The amount placed into the PCCRA would have been in addition to the sponsor's base risk retention requirement, and used to cover losses on the underlying assets before such losses were allocated to any other interest or account. In response to feedback received during the initial comment period, and in consideration of the use of fair value in the measurement of the standard risk retention amount in the Proposed Rule (as opposed to the par value measurement in the Original Proposal), the Agencies have decided not to include these heightened risk retention requirements in the Proposed Rule.

## Allocation to the Originator

The Proposed Rule permits a sponsor that chooses to retain risk under the standard risk retention option to offset the amount of its risk retention requirements by the amount of the eligible interests acquired by an originator of one or more of the securitized assets. To qualify for this offset of risk to an originator, the following conditions must be met at the closing of the securitization transaction:

- the originator acquires the eligible interest from the sponsor and retains the interest in the same manner as the sponsor under the standard risk retention option, as such interest was held prior to the acquisition by the originator;

[15] Section 4.01(5) of IRS Revenue Procedure 2003-84 defines a tender option termination event as: (i) a bankruptcy filing by or against a tax-exempt bond issuer; (ii) a downgrade in the credit-rating of a tax-exempt bond and a downgrade in the credit rating of any guarantor of the tax-exempt bond, if applicable, below investment grade; (iii) a payment default on a tax-exempt bond; (iv) a final judicial determination or a final IRS administrative determination of taxability of a tax-exempt bond for Federal default on the underlying municipal securities and credit enhancement, where applicable; (v) a credit rating downgrade below investment grade; (vi) the bankruptcy of the issuer and, when applicable, the credit enhancer; or (vii) the determination that the municipal securities are taxable.

- the ratio of the fair value of eligible interests acquired and retained by the originator to the total fair value of eligible interests otherwise required to be retained by the sponsor under the standard risk retention option does not exceed the ratio of: (i) the unpaid principal balance of all the securitized assets originated by the originator to (ii) the unpaid principal balance of all the securitized assets in the securitization transaction;
- the originator acquires and retains at least 20 percent of the aggregate risk retention amount otherwise required to be retained by the sponsor under the standard risk retention option; and
- the originator purchases the eligible interests from the sponsor at a price that is equal, on a dollar-for-dollar basis, to the amount by which the sponsor's required risk retention is reduced, by payment to the sponsor either in cash or as a reduction in the price received by the originator from the sponsor or depositor[16] for the assets sold by the originator to the sponsor or depositor for inclusion in the pool of securitized assets.

**Disclosure.** In addition to the disclosures required under the standard risk retention option, the sponsor must provide to potential investors a reasonable period of time prior to the sale of the ABS and, upon request, to the SEC and its appropriate federal banking agency, if any, the name and form of organization of any originator that will acquire and retain (or has acquired and retained) an interest in the transaction (including a description of the form, amount and nature of the interest), as well as the method of payment for such interest.

**Hedging, Transferring and Pledging.** The originator must comply with the hedging and other restrictions of the Proposed Rule as if it were the retaining sponsor.

**Sponsor's Duty to Comply.** The retaining sponsor is responsible for compliance and must maintain and adhere to policies and procedures that are reasonably designed to monitor compliance by each originator. In the event the sponsor determines that any originator no longer complies with any of these requirements, the sponsor must promptly notify the holders of the ABS interests of such noncompliance.

## Hedging, Transfer and Financing Restrictions

**Prohibited Transfers and Pledges.** Under the Proposed Rule, a retaining sponsor may not sell or otherwise transfer any interest or assets that the sponsor is required to retain, except to an entity that is and remains the sponsor's majority-owned affiliate. In addition, neither a retaining sponsor nor any of its affiliates may pledge any ABS interest that the sponsor is required to retain as collateral for any obligation (including a loan, repurchase agreement or other financing transaction) unless the obligation is with full recourse to the sponsor or affiliate, as applicable.

**Prohibited Hedging.** A retaining sponsor, its affiliates and the issuing entity may not purchase or sell a security, or other financial instrument, or enter into an agreement, derivative or other position, if (i) payments thereon or thereunder are materially related to the credit risk of one or more particular ABS interests that the retaining sponsor is required to retain or, in the case of the retaining sponsor and its affiliates, one or more of the particular securitized assets that collateralize the ABS and (ii) the security, instrument, agreement, derivative or position in any way reduces or limits the financial exposure of the sponsor to the credit risk.

**Permitted Hedging.** Under the Proposed Rule, the following activities constitute permitted hedging:

- hedging the interest rate risk or foreign exchange risk arising from one or more of the particular ABS interests required to be retained by the sponsor or one or more of the particular securitized assets that underlie the ABS; and

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[16] The Proposed Rule defines a "**depositor**" as (i) the person that receives or purchases and transfers or sells the securitized assets to the issuing entity; (ii) the sponsor, in the case of a securitization transaction where there is not an intermediate transfer of the assets from the sponsor to the issuing entity; or (iii) the person that receives or purchases and transfers or sells the securitized assets to the issuing entity in the case of a securitization transaction where the person transferring or selling the securitized assets directly to the issuing entity is itself a trust.

- purchasing or selling a security or other financial instrument or entering into an agreement, derivative or other position where payments thereon or thereunder are based, directly or indirectly, on an index of instruments that includes ABS if:
  - any class of ABS interests in the issuing entity that were issued in connection with the securitization transaction and that are included in the index represents no more than 10 percent of the dollar-weighted average (or corresponding weighted average in the currency in which the ABS is issued, as applicable) of all instruments included in the index; and
  - all classes of ABS interests in all issuing entities that were issued in connection with any securitization transaction in which the sponsor was required to retain an interest and that are included in the index represent, in the aggregate, no more than 20 percent of the dollar-weighted average (or corresponding weighted average in the currency in which the ABS is issued, as applicable) of all instruments included in the index.

**Transfer and Hedging Exception for Conservator or Receiver.** Under the Proposed Rule, a conservator or receiver of the sponsor (or any other person holding risk retention pursuant to the Proposed Rule) may sell or hedge any economic interest in a securitization transaction if the conservator or receiver has been appointed pursuant to any provision of federal or state law (or regulation promulgated thereunder) that provides for the appointment of the FDIC or an agency or instrumentality of the United States or of a state as conservator or receiver.

## GENERAL EXEMPTIONS

Pursuant to Section 15G(c)(1)(G) and Section 15G(e) of the Exchange Act, the Agencies must provide a complete or partial exemption from the risk retention requirements for certain types of securitization transactions.

### Exemption for Federally Insured or Guaranteed Residential, Multifamily and Health Care Mortgage Loan Assets

The Proposed Rule contains a total exemption from the risk retention requirements for any securitization transaction that:

- is collateralized solely by residential, multifamily or health care facility mortgage loan assets that are insured or guaranteed in whole or in part as to the payment of principal and interest by the U.S. or an agency thereof and by servicing assets; or
- involves the issuance of ABS that are (i) insured or guaranteed as to the payment of principal and interest by the U.S. or an agency thereof and (ii) collateralized solely by one of the categories of assets listed in the bullet above.

In addition, the Proposed Rule contains the following exemptions from the risk retention requirements for Federal Family Education Loan Program (**FFELP**) loans:

- a full exemption for any securitization transaction collateralized solely by FFELP loans that are guaranteed as to 100 percent of defaulted principal and accrued interest and by servicing assets;[17]
- a reduced risk retention requirement of 2 percent for any securitization transaction collateralized solely by FFELP loans that are guaranteed as to at least 98 percent of defaulted principal and accrued interest and by servicing assets;[18] and
- a reduced risk retention requirement of 3 percent for any securitization transaction collateralized solely by FFELP loans that are guaranteed as to at least 97 percent of defaulted principal and accrued

[17] These include FFELP loans with first disbursement prior to October 1993, or pursuant to certain limited circumstances where a full guarantee was required.

[18] These include FFELP loans with first disbursement between October 1993 and June 2006.

interest and by servicing assets.[19]

## Exemption for Securitizations of Assets Issued, Insured, or Guaranteed by the U.S. or any Agency of the U.S. and Other Exemptions

The Proposed Rule contains a total exemption from the risk retention requirements for any securitization transaction if the ABS issued are:

- (i) collateralized solely by obligations issued by the U.S. or an agency thereof and by servicing assets; (ii) collateralized solely by assets that are fully insured or guaranteed as to the payment of principal and interest by the U.S. or an agency thereof (other than the residential, multifamily or health care facility mortgage loan securitizations discussed in "Exemption for Federally Insured or Guaranteed Residential, Multifamily and Health Care Mortgage Loan Assets" above) and by servicing assets; or (iii) fully guaranteed as to the timely payment of principal and interest by the U.S. or any agency thereof;
- collateralized solely by loans or other assets made, insured, guaranteed or purchased by any institution that is subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation and by servicing assets;
- issued or guaranteed by any state of the U.S., by any political subdivision of a state or territory, or by any public instrumentality of a state or territory that is exempt from the registration requirements of the Securities Act of 1933, as amended (**Securities Act**) by reason of Section 3(a)(2) of the Securities Act; or
- securities that meet the definition of a "qualified scholarship funding bond" in Section 150(d)(2) of the Internal Revenue Code.[20]

The Proposed Rule specifically excludes from the exemptions described in this section securitization transactions involving the issuance of ABS that are issued, insured or guaranteed by, or collateralized by obligations issued by, or loans that are issued, insured or guaranteed by, Fannie Mae, Freddie Mac or a federal home loan bank.

## Exemption for Certain Resecuritization Transactions

The Proposed Rule contains an exemption from the risk retention requirements for ABS issued in certain resecuritization transactions (**resecuritization ABS**) if the transaction meets three conditions:

- the resecuritization transaction is collateralized solely by existing ABS issued in a securitization transaction for which credit risk was retained as required under the Proposed Rule, or which was otherwise exempted from the risk retention requirements (**compliant ABS**), and by servicing assets;
- the resecuritization transaction is structured so that it involves the issuance of only a single class of ABS interests; and
- the resecuritization transaction provides for a pass-through of all principal and interest payments received on the underlying ABS (net of expenses of the issuing entity) to the holders of the resecuritization ABS.

The Proposed Rule also contains an exemption from the risk retention requirements for first-pay class securitizations.[21] To qualify for this exemption, the transaction must meet the following conditions:

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[19] These include FFELP loans with first disbursement of July 2006 or later.

[20] *See* 26 U.S.C. 150(d)(2).

[21] The Proposed Rule defines "**first-pay class**" as a class of ABS interests for which all interests in the class are entitled to the same priority of principal payment and that, at the time of the closing of the transaction, is entitled to repayments of principal and payments of interest prior to or *pro rata* with all other classes of securities collateralized by the same pool of first-lien residential mortgages until such class has no principal or notional balance remaining.

- the transaction is collateralized solely by first-pay classes of ABS which are compliant ABS collateralized by first-lien residential mortgages on properties located in the U.S. and by servicing assets;
- all ABS interests issued in the securitization transaction share *pro rata* in any realized principal losses based on the unpaid principal balance of the ABS interests at the time the loss is realized;
- the transaction is structured to reallocate pre-payment risk and does not reallocate credit risk (other than credit risk reallocated only as a collateral consequence of reallocating pre-payment risk); and
- the resecuritization transaction does not include any inverse floater[22] or any similarly structured class of ABS.

## Other Exemptions From Risk Retention Requirements

**Utility Legislative Securitizations.** The Proposed Rule exempts securitization transactions where the ABS are issued by an entity that is wholly owned, directly or indirectly, by an investor-owned utility company that is subject to the regulatory authority of a state public utility commission or other appropriate state agency, subject to a requirement that the ABS are secured by the intangible property right to collect charges for certain "specified costs"[23] and other assets of the entity.

**Seasoned Loans.** The Proposed Rule exempts securitization transactions that are collateralized solely by seasoned loans that have not been modified since origination and have never been delinquent for 30 days and by servicing assets. For residential mortgage loans, a "**seasoned loan**" is a loan that (i) has been outstanding and performing for the longer of five years or the period until the outstanding principal balance of the loan has been reduced to 25 percent of the original principal balance or (ii) has been outstanding and performing for at least seven years. For all other asset classes, a "**seasoned loan**" is a loan that has been outstanding and performing for the longer of (i) two years or (ii) the period until the outstanding principal balance of the loan has been reduced to 33 percent of the original principal balance.

**Other Requested Exemptions.** In response to the Original Proposal, commenters urged the Agencies to create exemptions for the following types of transactions: legacy loan securitizations, corporate debt repackagings, "nonconduit" CMBS transactions, transactions involving tax-lien backed securities sponsored by a municipal entity, and rental car securitizations. The Agencies declined and specific exemptions for these transactions are not included in the Proposed Rule.

## Safe Harbor for Foreign Securitization Transactions

The Proposed Rule contains an exemption from the risk retention requirements for ABS issued in certain securitization transactions by foreign entities. The exemption is available if:

- the securitization transaction is not required to be and is not registered under the Securities Act;
- no more than 10 percent of the dollar value by proceeds (or equivalent amount in the currency in which the ABS is issued, as applicable) of all classes of ABS interests sold in the securitization transaction are sold or transferred to U.S. persons[24] or for the account or benefit of U.S. persons;

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[22] The Proposed Rule defines "**inverse floater**" as an ABS interest issued as part of a securitization transaction for which interest or other income is payable to the holder based on a rate or formula that varies inversely to a reference rate of interest.

[23] The Proposed Rule defines "**specified costs**" as any cost identified by a state legislature as appropriate for recovery through securitization pursuant to legislation that (i) authorizes the utility company to apply for, and authorizes the public utility commission or other appropriate state agency to issue, a financing order determining the amount of specified costs the utility will be allowed to recover; (ii) provides that pursuant to a financing order, the utility acquires an intangible property right to charge, collect and receive amounts necessary to provide for the full recovery of the specified costs determined to be recoverable, and assures that the charges are nonbypassable and will be paid by customers within the utility's historic service territory who receive utility goods or services through the utility's transmission and distribution system, even if those customers elect to purchase these goods or services from a third party; and (iii) guarantees that neither the state nor any of its agencies has the authority to rescind or amend the financing order, to revise the amount of specified costs, or in any way to reduce or impair the value of the intangible property right, except as may be contemplated by periodic adjustments authorized by the specified cost recovery legislation.

[24] For purposes of this safe harbor, a "**U.S. person**" includes: (i) any natural person resident in the U.S.; (ii) any partnership, corporation, limited

- neither the sponsor of the securitization transaction nor the issuing entity is a U.S.-located entity;[25] and
- if the sponsor or issuing entity is chartered, incorporated or organized under the laws of a jurisdiction other than the U.S. or a U.S. state or territory, no more than 25 percent (based on the unpaid principal balance) of the assets collateralizing the ABS interest sold in the securitization transaction were acquired by the sponsor, directly or indirectly, from (i) a majority-owned affiliate of the sponsor or issuing entity that is chartered, incorporated, or organized under the laws of the U.S. or a U.S. state or territory or (ii) an unincorporated branch or office of the sponsor or issuing entity that is located in the U.S.

The safe harbor is not available for any foreign securitization transaction that meets the technical conditions of the safe harbor but is part of a plan or scheme to evade the risk retention requirement regulations.

## Sunset on Hedging and Transfer Restrictions

In response to comments on the Original Proposal, the Proposed Rule limits the period for which the transfer and hedging restrictions apply. The Agencies have proposed two sets of sunset provisions on the transfer and hedging restrictions: one for residential mortgage-backed securities (**RMBS**) and one for other types of ABS.

- **RMBS.** If all of the assets that collateralize a securitization transaction are residential mortgages, the prohibitions on sale and hedging by the sponsor and its affiliates (other than the prohibitions relating to hedging by the issuing entity) expire on or after the date that is the earlier of (i) the date that is seven years after the date of the closing of the securitization transaction and (ii) the later of (a) the date that is five years after the closing date and (b) the date on which the total unpaid principal balance of the residential mortgages that collateralize the securitization transaction has been reduced to 25 percent of the total unpaid principal balance of such residential mortgages on the closing date.
- **Other ABS.** For non-RMBS securitizations, the prohibitions on the sale and hedging by the sponsor and its affiliates (other than the prohibitions relating to hedging by the issuing entity) expire on or after the date that is the latest of: (i) the date on which the total unpaid principal balance of the securitized assets that collateralize the securitization transaction has been reduced to 33 percent of the total unpaid principal balance of the securitized assets as of the closing date; (ii) the date on which the total unpaid principal obligations under the ABS interests issued in the securitization transaction have been reduced to 33 percent of the total unpaid principal obligations of the ABS interests on the closing date; and (iii) two years after the closing date.

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liability company or other organization or entity organized or incorporated under the laws of the U.S. or any U.S. state or territory; (iii) any estate of which any executor or administrator is a U.S. person; (iv) any trust of which any trustee is a U.S. person; (v) any agency or branch of a foreign entity located in the U.S.; (vi) any nondiscretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a U.S. person; (vii) any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated or (if an individual) resident in the U.S.; and (viii) any partnership, corporation, limited liability company or other organization or entity if (a) organized or incorporated under the laws of any foreign jurisdiction and (b) formed by a U.S. person principally for the purpose of investing in securities not registered under the Securities Act.

A U.S. person does not include: (i) any discretionary account or similar account (other than an estate or trust) held for the benefit or account of a non-U.S. person by a dealer or other professional fiduciary organized, incorporated or (if an individual) resident in the U.S.; (ii) any estate of which any professional fiduciary acting as executor or administrator is a U.S. person if (a) an executor or administrator of the estate who is not a U.S. person has sole or shared investment discretion with respect to the assets of the estate and (b) the estate is governed by foreign law; (iii) any trust of which any professional fiduciary acting as trustee is a U.S. person, if a trustee who is not a U.S. person has sole or shared investment discretion with respect to the trust assets, and no beneficiary of the trust (and no settlor if the trust is revocable) is a U.S. person; (iv) an employee benefit plan established and administered in accordance with the law of a country other than the U.S. and customary practices and documentation of such country; (v) any agency or branch of a U.S. person located outside the U.S. if the agency or branch operates for valid business reasons and is engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation, respectively, in the jurisdiction where located; or (vi) the International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the United Nations and their agencies, affiliates and pension plans, and any other similar international organizations, their agencies, affiliates and pension plans.

[25] A "**U.S.-located entity**" is an entity that is (i) chartered, incorporated or organized under the laws of the U.S. or a U.S. state or territory, (ii) an unincorporated branch or office of an entity chartered, incorporated or organized under the laws of the U.S. or a U.S. state or territory or (iii) an unincorporated branch or office located in the U.S. of an entity not chartered, incorporated or organized under the laws of the U.S. or a U.S. state or territory.

## Federal Deposit Insurance Corporation Securitizations

The Proposed Rule contains an exemption from risk retention for securitization transactions that are sponsored by the FDIC acting as conservator or receiver under any provision of the Federal Deposit Insurance Act or of Title II of the Dodd-Frank Act.

# REDUCED RISK RETENTION REQUIREMENTS AND UNDERWRITING STANDARDS FOR ABS BACKED BY QUALIFYING COMMERCIAL, COMMERCIAL REAL ESTATE OR AUTOMOBILE LOANS

The Proposed Rule includes an exemption from the risk retention requirements for securitizations of qualifying commercial loans, qualifying commercial real estate (**CRE**) loans and qualifying automobile loans. To qualify for this exemption, the following conditions must be satisfied:

- the assets must meet the underwriting standards described below;
- the depositor must make the certification described in "Internal Controls and Cure or Buyback Requirement" below;
- the securitization transaction must be collateralized solely by loans of the same asset class and by servicing assets;
- the securitization transaction must not permit reinvestment periods; and
- the sponsor must provide the disclosure described below.

As discussed in further detail in "Blended Pool of Qualifying and Nonqualifying Loans" below, securitization transactions collateralized by blended pools of qualifying and nonqualifying loans can qualify for a reduction of up to half of the 5 percent risk retention requirement.

**Disclosure.** The sponsor must disclose to potential investors a reasonable period of time prior to the sale of ABS and, upon request, to the SEC and to its appropriate federal banking agency, if any:

- a description of the manner in which the sponsor determined the aggregate risk retention requirement for the securitization transaction after including qualifying commercial loans, qualifying CRE loans or qualifying automobile loans with 0 percent risk retention; and
- descriptions of the qualifying loans and descriptions of the assets that are not qualifying loans, and the material differences between the group of qualifying loans and the group of assets that are not qualifying loans with respect to the composition of each group's loan balances, loan terms, interest rates, borrower credit information and characteristics of any loan collateral.

## Qualifying Commercial Loans

**Underwriting Standards.** Under the Proposed Rule, a "**commercial loan**" is a secured or unsecured loan to a company or an individual for business purposes, other than any (i) loan to purchase or refinance a one-to-four family residential property or (ii) commercial real estate loan (as defined below in "Qualifying Commercial Real Estate Loans"). For a commercial loan to constitute a qualifying commercial loan under the Proposed Rule, the following underwriting criteria must be satisfied:

- prior to origination of the commercial loan, the originator must:
  - verify and document the financial condition of the borrower: (i) as of the end of the borrower's two most recently completed fiscal years; and (ii) during the period, if any, since the end of its most recently completed fiscal year;
  - conduct an analysis of the borrower's ability to service its overall debt obligations during the next two years, based on reasonable projections;

- determine that, based on the previous two years' actual performance, the borrower has: (i) a total liabilities ratio of 50 percent or less; (ii) a leverage ratio of 3.0 or less; and (iii) a debt service coverage (**DSC**) ratio of 1.5 or greater; and
- determine that, based on the two years of projections, which include the new debt obligation, following the closing date of the loan, the borrower will have: (i) a total liabilities ratio of 50 percent or less; (ii) a leverage ratio of 3.0 or less; and (iii) a DSC ratio of 1.5 or greater.

- prior to, upon or promptly following the inception of the loan, the originator must obtain: (i) if the loan is originated on a secured basis, a perfected security interest (by filing, title notation or otherwise) or, in the case of real property, a recorded lien, on all of the property pledged to collateralize the loan; and (ii) if the loan documents indicate the purpose of the loan is to finance the purchase of tangible or intangible property, or to refinance such a loan, a first lien on the property.
- the loan documentation for the commercial loan must include covenants that:
  - require the borrower to provide the borrower's financial statements and supporting schedules to the servicer of the commercial loan on an ongoing basis (but not less frequently than quarterly);
  - prohibit the borrower from retaining or entering into a debt arrangement that permits payments-in-kind;
  - impose limits on the creation or existence of any other security interest or lien on the property that serves as collateral for the loan; and
  - require the borrower and any other party that pledges collateral for the loan to take any action required to perfect or protect the security interest or first lien on the collateral and to maintain the collateral (including by paying taxes and other charges and by maintaining insurance that protects against loss on the collateral at least up to the amount of the commercial loan).
- loan payments required under the loan agreement must be (i) based on straight-line amortization of principal and interest that fully amortize the debt over a term that does not exceed five years from the date of origination; and (ii) required to be made no less frequently than quarterly over a term that does not exceed five years.
- the primary source of repayment for the loan must be revenue from the business operations of the borrower.
- the loan must have been funded within the six months prior to the closing of the securitization transaction.
- at the closing of the securitization transaction, all payments due on the loan must be contractually current.

## Qualifying Commercial Real Estate Loans

**Underwriting Standards.** Under the Proposed Rule, a "**commercial real estate loan**" is a loan secured by a property with five or more single family units, or by nonfarm nonresidential real property, the primary source (50 percent or more) of repayment for which is expected to be (i) the proceeds of the sale, refinancing, or permanent financing of the property or (ii) rental income associated with the property.[26] For a commercial real estate loan to constitute a qualifying commercial real estate loan under the Proposed Rule, the following underwriting criteria must be satisfied:

[26] The definition excludes land development and construction loans (including one-to-four family residential or commercial construction loans), other land loans and unsecured loans to a developer.

- the CRE loan must be secured by:
  - an enforceable first lien on the commercial real estate and improvements;
  - an assignment of leases, rents, other occupancy agreements, franchise agreements, license agreements and concession agreements related to the commercial real estate or improvements or the operation thereof for which the borrower or an operating affiliate is a lessor, licensor, concession granter or similar party and all payments due to the borrower or due to any operating affiliate in connection with the operation of the property; and
  - a security interest (which must be perfected if it can be perfected by the filing of a financing statement, fixture filing or similar document) in all interests of the borrower and any applicable operating affiliate in all tangible and intangible personal property in or used in the operation of or in connection with any of the collateral.
- prior to origination of the CRE loan, the originator must:
  - verify and document the current financial condition of the borrower and each operating affiliate;
  - obtain a written appraisal of the real property securing the loan that 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;[27]
  - qualify 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, not exceeding 25 years, or 30 years for a qualifying multifamily property;[28]
  - conduct an environmental risk assessment of the property securing the loan and take appropriate steps to mitigate any environmental liability determined to exist based on this assessment;
  - conduct an analysis of the borrower's ability to service its overall debt obligations during the next two years, based on reasonable projections;
  - determine that, based on the previous two years' actual performance, the borrower had: (i) a DSC ratio of 1.5 or greater, if the loan is a qualifying leased CRE loan,[29] net of any income derived from a tenant(s) who is not a qualified tenant(s);[30] (ii) a DSC ratio of 1.25 or greater, if the loan is a qualifying multifamily property loan; or (iii) a DSC ratio of 1.7 or greater, if the loan is any other type of CRE loan; and
  - determine that, based on two years of projections, which include the new debt obligation, following the origination date of the loan, the borrower will have: (i) 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); (ii) a DSC ratio of 1.25 or greater, if the loan is a qualifying multifamily property loan; or (iii) a DSC ratio of 1.7 or greater, if the loan is any other type of CRE loan.
- the loan documentation for the CRE loan must include covenants that:

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[27] The appraisal must be performed not more than six months from the origination date of the loan by an appropriately state-certified or state-licensed appraiser and conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice promulgated by the Appraisal Standards Board and the appraisal requirements of the federal banking agencies.

[28] "**Qualifying multifamily loan**" means a CRE loan secured by any residential property (other than a hotel, motel, inn, hospital, nursing home or other similar facility where dwellings are not leased to residents): (i) that consists of five or more dwelling units (including apartment buildings, condominiums, cooperatives and other similar structures) primarily for residential use; and (ii) where at least 75 percent of the net operating income is derived from residential rents and tenant amenities (including income from parking garages, health or swim clubs and dry cleaning), and not from other commercial uses.

[29] "**Qualifying leased CRE loan**" means a CRE loan secured by commercial nonfarm real property, other than a multifamily property or a hotel, inn or similar property: (i) that is occupied by one or more qualified tenants pursuant to a lease agreement with a term of no less than one month; and (ii) where no more than 20 percent of the aggregate gross revenue of the property is payable from one or more tenants who: (a) are subject to a lease that will terminate within six months following the date of origination; or (b) are not qualified tenants.

[30] "**Qualified tenant**" means (i) a tenant with a lease who has satisfied all obligations with respect to the property in a timely manner; or (ii) a tenant who originally had a lease that subsequently expired and currently is leasing the property on a month-to-month basis, has occupied the property for at least three years prior to the date of origination, and has satisfied all obligations with respect to the property in a timely manner.

  - require the borrower to provide the borrower's financial statements and supporting schedules to the servicer 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;
  - impose prohibitions on the creation or existence of any other security interest with respect to the collateral for the CRE loan (except for purchase money security interests and junior liens as described below); and
  - require each borrower and each operating affiliate to take any action required to protect or perfect (to the extent that any security interest is required to be perfected) the security interest on the collateral and to maintain the collateral (including by (i) paying taxes and other charges; (ii) maintaining insurance that protects against loss on the collateral at least up to the amount of the CRE loan; (iii) complying with all environmental, zoning, building code, licensing and other laws and regulations applicable to the collateral; and (iv) complying with leases, franchise agreements, condominium declarations and other documents and agreements relating to the operation of the collateral, and not modifying 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).

- the loan documentation for the CRE loan must prohibit the borrower and each operating affiliate from obtaining a loan secured by a junior lien on the collateral, unless (i) the sum of the principal amount of such junior lien loan, plus the principal amount of all other loans secured by the collateral, does not exceed the applicable CLTV ratio,[31] based on the appraisal at origination of such junior lien loan or (ii) such loan is a purchase money obligation that financed the acquisition of machinery or equipment and the borrower or operating affiliate (as applicable) pledges such machinery and equipment as additional collateral for the CRE loan.
- at origination, the applicable loan-to-value ratios for the loan must be: (i) LTV[32] less than or equal to 65 percent and CLTV less than or equal to 70 percent; or (ii) if the capitalization rate used in the appraisal[33] is less than or equal to the sum of: (a) the 10-year swap rate[34] as of the effective date of the appraisal and (b) 300 basis points, LTV less than or equal to 60 percent and CLTV less than or equal to 65 percent.
- all loan payments required to be made under the loan agreement must be (i) based on straight-line amortization of principal and interest over a maximum term of 25 years, or 30 years for a qualifying multifamily loan and (ii) required to be made no less frequently than monthly over a term of at least 10 years.
- under the terms of the loan agreement: (i) any maturity of the note must occur no earlier than 10 years following the date of origination; (ii) the borrower must not be permitted to defer repayment of principal or payment of interest; and (iii) the interest rate on the loan must be (a) a fixed interest rate or (b) an adjustable interest rate and the borrower, prior to or at the time the CRE loan is originated, must obtain a derivative that results in a fixed interest rate.
- the originator must not establish an interest reserve at origination to fund all or part of a payment on the loan.

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[31] "**Combined loan-to-value (CLTV) ratio**" means, at the time of origination, the sum of the principal balance of a first-lien mortgage loan on the property, plus the principal balance of any junior-lien mortgage loan that, to the creditor's knowledge, would exist at the closing of the transaction and that is secured by the same property, divided by: (i) for acquisition funding, the lesser of the purchase price or the estimated market value of the real property based on the required appraisal or (ii) for refinancing, the estimated market value of the real property based on the required appraisal.

[32] "**Loan-to-value (LTV) ratio**" means, at the time of origination, the principal balance of a first-lien mortgage loan on the property divided by: (i) for acquisition funding, the lesser of the purchase price or the estimated market value of the real property based on the required appraisal or (ii) for refinancing, the estimated market value of the real property based on the required appraisal.

[33] The capitalization rate used must be disclosed to potential investors.

[34] As reported in the Federal Reserve Board's H.15 Report (or any successor report).

- at the closing of the securitization transaction, all payments due on the loan must be contractually current.
- within two weeks of the closing of the CRE loan (or, if sooner, prior to the transfer of such CRE loan to the issuing entity), the originator must have obtained a UCC lien search from the jurisdiction of organization of the borrower and each operating affiliate that does not report, as of the time that the security interest of the originator in the property was perfected, other higher priority liens of record (other than purchase money security interests).

## Qualifying Automobile Loans

**Underwriting Standards.** Under the Proposed Rule, an "**automobile loan**" is any loan to an individual to finance the purchase of, and that is secured by a first lien on, a passenger car or other passenger vehicle, such as a minivan, van, sport-utility vehicle, pickup truck, or similar light truck for personal, family or household use. The term does not include any (i) loan to finance fleet sales, (ii) personal cash loan secured by a previously purchased automobile, (iii) loan to finance the purchase of a commercial vehicle or farm equipment that is not used for personal, family, or household purposes, (iv) lease financing, (v) loan to finance the purchase of a vehicle with a salvage title or (vi) loan to finance the purchase of a vehicle intended to be used for scrap or parts. For an automobile loan to constitute a qualifying automobile loan under the Proposed Rule, the following underwriting criteria must be satisfied:

- prior to origination of the automobile loan, the originator must:
  - verify and document that within 30 days of the date of origination:
    - the borrower was not currently 30 days or more past due, in whole or in part, on any debt obligation;
    - within the previous 24 months, the borrower has not been 60 days or more past due, in whole or in part, on any debt obligation;
    - within the previous 36 months, the borrower has not: (a) been a debtor in a proceeding commenced under Chapter 7 (Liquidation), Chapter 11 (Reorganization), Chapter 12 (Family Farmer or Family Fisherman plan), or Chapter 13 (Individual Debt Adjustment) of the U.S. Bankruptcy Code; or (b) been the subject of any federal or state judicial judgment for the collection of any unpaid debt;
    - within the previous 36 months, no one-to-four family property owned by the borrower has been the subject of any foreclosure, deed in lieu of foreclosure or short sale; and
    - within the previous 36 months, the borrower has not had any personal property repossessed.

      An originator will be deemed to have met these verification requirements if, no more than 30 days before the closing of the loan, the originator obtains a credit report regarding the borrower that shows that the borrower meets all of these requirements (and no information in a credit report subsequently obtained by the originator before the closing of the loan contains contrary information).
  - determine and document that the borrower has at least 24 months of credit history; and
  - determine and document that, upon the origination of the loan, the borrower's debt to income (**DTI**) ratio is less than or equal to 36 percent. For the purpose of making this determination, the originator must (i) verify and document all income of the borrower that the originator includes in the borrower's effective monthly income (using payroll stubs, tax returns, profit and loss statements, or other similar documentation); and (ii) on or after the date of the borrower's written application and prior to origination, obtain a credit report regarding the borrower and verify that all outstanding debts reported in the borrower's credit report are incorporated into the calculation of the borrower's DTI ratio.

- at closing of the automobile loan, the borrower must make a down payment from the borrower's personal funds and trade-in allowance, if any, that is at least equal to the sum of: (i) the full cost of the vehicle title, tax and registration fees; (ii) any dealer-imposed fees; (iii) the full cost of any additional warranties, insurance or other products purchased in connection with the purchase of the vehicle; and (iv) 10 percent of the vehicle purchase price.
- the originator must record a first lien securing the loan on the purchased vehicle in accordance with state law.
- the terms of the loan agreement must provide a maturity date for the loan that does not exceed the lesser of (i) six years from the date of origination or (ii) 10 years minus the difference between the current model year and the vehicle's model year.
- the terms of the loan agreement must (i) specify a fixed rate of interest for the life of the loan; (ii) provide for a level monthly payment amount that fully amortizes the amount financed over the loan term; (iii) not permit the borrower to defer repayment of principal or payment of interest; and (iv) require the borrower to make the first payment on the automobile loan within 45 days of the loan's contract date.
- at the closing of the securitization transaction, all payments due on the loan must be contractually current.

## Blended Pool of Qualifying and Nonqualifying Loans

The Proposed Rule allows for a reduction in the risk retention requirement for securitizers of "blended pools" of collateral comprised of qualified and nonqualified commercial loans, CRE loans and automobile loans, provided that all loans in the blended pool are from the same asset class (*i.e.*, a mixed pool of commercial and automobile loans would not qualify). The standard 5 percent risk retention requirement may be reduced by the ratio, measured as of the cut-off date, of the combined unpaid principal balance of qualified loans to the total unpaid principal balance of the loans in the pool, provided that regardless of the composition of the pool, the minimum required risk retention for blended pools is 2.5 percent.

## Internal Controls and Cure or Buyback Requirement

For a qualifying commercial loan, qualifying commercial real estate loan or qualifying automobile loan to be eligible for a total or partial exemption from the risk retention rules, the depositor of the ABS must certify that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all of the qualified loans meet all of the underwriting standards described above and has concluded that its internal supervisory controls are effective. Such evaluation must occur within 60 days of the cut-off date or similar date for establishing the composition of the asset pool collateralizing the ABS. The sponsor must provide a copy of such certification to potential investors a reasonable period of time prior to the sale of the ABS, and upon request, to its appropriate Federal banking agency, if any.

If a sponsor has relied on the exemption provided for qualifying commercial loans, qualifying commercial real estate loans or qualifying automobile loans and it is subsequently determined that a loan did not the meet all of the underwriting requirements, the sponsor will not lose the benefit of such exemption with respect to the loan if the depositor complied with the certification requirement discussed in the preceding paragraph and:

- the failure of the loan to meet any of the applicable requirements is not material; or
- no later than 90 days after the determination that the loan does not meet one or more of the applicable requirements, the sponsor (i) effectuates cure and establishes conformity of the loan to

the unmet requirements as of the date of the cure, or (ii) 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) as of the date of repurchase.

If the sponsor cures or repurchases the loan, the sponsor must promptly notify the holders of the ABS of any loan included in the securitization transaction that is required to be cured or repurchased, including the principal amount of such loan and the cause for cure or repurchase.

## QUALIFIED RESIDENTIAL MORTGAGES

The Proposed Rule exempts a sponsor from the risk retention requirements with respect to any securitization transaction if (i) all of the assets that collateralize the ABS are qualified residential mortgages (**QRMs**) or servicing assets, (ii) none of the assets that collateralize the ABS are other ABS and (iii) at closing, all of the QRMs are currently performing.[35] Additionally, to qualify for the QRM exemption, the depositor must certify that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the ABS are QRMs or servicing assets and has concluded that its internal supervisory controls are effective. This evaluation of internal supervisory controls must be performed within 60 days of the cut-off date or similar date for establishing the composition of the asset pool collateralizing the ABS, and the sponsor must provide a copy of the certification to potential investors a reasonable period of time prior to the sale of asset-backed securities in the issuing entity and, upon request, to the SEC and its appropriate federal banking agency, if any.

### Proposed Definition of QRM

Under the Proposed Rule, a QRM is linked to the definition of "qualified mortgage" (**QM**) in Section 129C of the Truth in Lending Act and its implementing regulations.[36] The implementing regulations provide several definitions of a QM, all of which would qualify as a QRM. The following loan products are expressly excluded from the QM definitions, and therefore are also excluded from the QRM definition: home-equity lines of credit, reverse mortgages, timeshares and temporary loans or "bridge" loans of 12 months or less. The scope of covered loans includes any closed-end loan secured by any dwelling (*e.g.*, home purchase, refinances, home equity lines and second or vacation homes), and both first liens and subordinate liens.

**General QM Definition.** The general definition of a QM requires that the loan meet the following criteria:

- regular periodic payments that are substantially equal;
- no negative amortization, interest only, or balloon features;
- a maximum loan term of 30 years;
- total points and fees that do not exceed 3 percent of the total loan amount, or the applicable amounts specified in the final QM rule, for small loans up to $100,000;
- payments underwritten using the maximum interest rate that may apply during the first five years after the date on which the first regular periodic payment is due;
- consideration and verification of the consumer's income and assets, including employment status if relied upon, current debt obligations, mortgage related obligations, alimony and child support; and
- total debt-to-income ratio that does not exceed 43 percent.

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[35] Under the Proposed Rule, "**currently performing**" means the borrower in the mortgage transaction is not currently 30 days past due, in whole or in part, on the mortgage transaction.

[36] 15 U.S.C. 1639c.

**Temporary QM Definition.** Loans that meet the following criteria also qualify as QM if the underlying transaction is consummated before January 10, 2021:

- regular periodic payments that are substantially equal;
- no negative amortization, interest-only or balloon features;
- a maximum loan term of 30 years;
- total points and fees that do not exceed 3 percent of the total loan amount, or the applicable amounts specified for small loans up to $100,000; and
- eligibility for purchase, guarantee or insurance by an Enterprise, HUD, the Veterans Administration, the U.S. Department of Agriculture or the Rural Housing Service.

The temporary QM definition does not require a mortgage to meet certain criteria necessary to qualify for the general QM definition, including: payments being underwritten using the maximum interest rate that may apply during the first five years, consideration and verification of the borrower's income, assets and debt obligations, and the borrower meeting a maximum debt-to-income ratio.

**Additional QM Definitions.** Three additional QM definitions apply to small creditor portfolio loans. These are available only to small creditors that meet certain criteria including: (i) the creditor originated 500 or fewer transactions secured by a first lien and (ii) the creditor had total assets of less than $2 billion. Because these loans must be held for at least three years to maintain QM status, they would be ineligible for QRM status for three years (as they could not be sold).

The first of these definitions allows these creditors to originate loans as QMs with greater underwriting flexibility, including without a quantitative debt-to-income threshold.[37] The second provides for a two-year transition period in which these creditors can originate balloon loans as QMs.[38] The last QM definition allows eligible small creditors that operate predominantly in rural or underserved areas to originate balloon-payment loans QMs if they meet certain other criteria.[39]

## Repurchase of Loans Subsequently Determined to be Nonqualified After Closing

Under the Proposed Rule, a sponsor that has relied on the QRM exemption for an ABS transaction will not lose its exemption for that transaction if, after closing, it is determined that one or more of the residential mortgage loans collateralizing the ABS does not meet all of the QRM criteria, provided that certain criteria are met. To maintain the exemption in such a case: (i) the depositor must have complied with the requirements relating to certification of internal supervisory controls; (ii) no later than 90 days after the determination that the loans do not meet the QRM criteria, the sponsor must repurchase the non-QRM loans from the issuing entity at a price at least equal to the remaining aggregate unpaid principal balance and accrued interest on the loans; and (iii) the sponsor must promptly notify the ABS holders of any loans included in the securitization transaction that are required to be repurchased, including the amount of the repurchased loans and the cause for the repurchase.

## Alternative Approach to Exemptions for QRMs

The agencies also are seeking input on an alternative approach, referred to as "**QM-plus**." Significantly fewer loans would qualify as QRMs under this approach. The QM-plus approach would adopt the criteria detailed in the general QM definition above and add the following four additional factors:

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[37] 12 CFR 1023(e)(5).

[38] 12 CFR 1023(e)(6).

[39] 12 CFR 1023(f).

- loans must be secured by one-to-four family real properties that constitute the principal dwelling of the borrower;
- QRMs must be first-lien mortgages, provided that junior liens are permitted for refinance QRMs;
- the originator must determine that the borrower:
  - was not 30 days or more past due on any debt obligation;
  - had not been 60 days or more past due on any debt obligation within the last 24 months; and
  - had not been a debtor in a bankruptcy proceeding, judgment for collection of unpaid debt, repossession, foreclosure or action in lieu of foreclosure; and
- the loan to value ratio must be no greater than 70 percent, with property value determined by an appraisal; for refinance QRMs, the loan to value ratio must account for junior liens, with property value determined as the lower of (i) the appraisal amount or (ii) the contract price at closing.

Loans that would qualify under the other QM definitions, including GSE-eligible covered transactions, small creditor exceptions or balloon loan provisions, would not be considered QRMs under the QM-plus approach.

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