American Financial Services Association

August 1, 2011

Office of the Comptroller of the Currency
250 E Street, SW, Mail Stop 2-3
Washington, DC 20219
Docket Number OCC-2011-0002
regs.comments@occ.treas.gov

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue
Washington, DC 20551
Docket No. R-1411
regs.comments@federalreserve.gov

Robert E. Feldman, Executive Secretary
Attn: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
RIN 3064-AD74
comments@fdic.gov

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
File Number S7-14-11
rule-comments@sec.gov

Alfred M. Pollard, General Counsel
Attn: Comments/RIN 2590-AA43
Federal Housing Finance Agency
1700 G Street, NW, Fourth Floor
Washington, DC 20552
regcomments@fhfa.gov

Regulations Division, Office of General Counsel
Department of Housing and Urban Development
451 7th Street SW, Room 10276
Washington, DC 20410-0500
FR-5504-P-01, Credit Risk Retention
www.regulations.gov

Re: Credit Risk Retention

[RIN 1557-AD40; 7100 AD 70; 3064-AD74; 3235-AK96; 2590-AA43; 2501-AD53]

Dear Ladies and Gentlemen:

This letter is submitted by the American Financial Services Association ("AFSA") in response to the request of the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Securities and Exchange Commission and the Department of Housing and Urban Development (collectively, the "Agencies") for comments on the proposed rule entitled *Credit Risk Retention* (the "Proposed Rule").[1] The Proposed Rule has been issued by the Agencies to implement Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), which adds Section 15G to the Securities Exchange Act of 1934 (the "Exchange Act"),[2] to require securitizers of asset-backed securities

[1] Credit Risk Retention, 76 Fed. Reg. 24,090 (Apr. 29, 2011).

[2] 15 U.S.C. § 78*o*-11. References in the remainder of this letter refer to Section 15G of the Exchange Act, as added by the Dodd-Frank Act, and do not make citation to Title 15 of the U.S. Code.

("ABS") to retain not less than five percent of the credit risk associated with the assets collateralizing the ABS. AFSA appreciates the opportunity to provide its comments on the Proposed Rule.

AFSA is the national trade association for the consumer credit industry, protecting access to credit and consumer choice. Its 350 members include consumer and commercial finance companies, auto finance and leasing companies, mortgage lenders, mortgage servicers, credit card issuers, industrial banks and industry suppliers. Many of AFSA's members issue ABS as a critical source of corporate funding and liquidity, which allows them to provide consumer credit products to the general public. AFSA and its members agree with the comment in the Proposed Rule that, "the securitization markets are an important source of credit to U.S. households and businesses and state and local governments."[3] The Dodd-Frank Act recognizes the importance of affordable, available credit – of the type historically provided by the securitization markets – to the general recovery and growth of the U.S. economy. In fact, Section 941 of the Dodd-Frank Act explicitly requires the Agencies to adopt implementing rules which, among other things:

- consider "the potential impact of the risk retention obligations on the access of consumers and businesses to credit on reasonable terms,"[4] and
- "improve the access of consumers and businesses to credit on reasonable terms[.]"[5]

The Agencies must also study and issue a report on the impact that credit risk retention requirements would have "on the continued viability of the [ABS] markets and on the availability of credit for new lending[.]"[6]

AFSA supports the legislative intent of Section 941 to encourage sound underwriting and to align the interests of asset originators and securitization sponsors with the interests of ABS investors. AFSA also supports the Dodd-Frank Act's larger objective to eliminate those market practices that contributed to the recent financial crisis. AFSA believes, however, that these objectives must be adequately balanced with the ability for market participants to meet the needs of creditworthy borrowers. The Proposed Rule fails to ensure that the risk retention requirements will not stifle credit availability to U.S. consumers and borrowers and not chill economic growth and recovery.

As a threshold matter, due to the number of issues and policy considerations implicated by the Proposed Rule, and the implications of other provisions in the Dodd-Frank Act, we believe that the Agencies should carefully deliberate before issuing any final rule on risk retention. The Proposed Rule is expected to, and in fact has, elicited considerable comment from a wide array of interested parties, including members of the financial industry, consumer protection interest groups and members of Congress. It requests comments on more than 170 specific and substantive questions related to the various provisions. Given the breadth of interests and considerations embodied in the Proposed Rule, we respectfully suggest that the

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3 76 Fed. Reg. at 24,093.
4 Exchange Act, § 15G(d)(2)(C).
5 Exchange Act, § 15G(c)(2)(B).
6 Dodd-Frank Act, § 941(c); *see also* Board of Governors of the Federal Reserve System, *Report to the Congress on Risk Retention* (Oct. 2010).

Agencies should consider all comments received, issue a new notice of proposed rulemaking and solicit a second round of comments prior to implementing any final rule.[7]

Impact of Other Provisions of the Dodd-Frank Act. The Proposed Rule should consider more fully the impact of other statutory provisions designed to regulate the conduct of participants in the securitization industry. Although the Proposed Rule makes reference to several provisions of the Dodd-Frank Act that also increase the regulation and supervision of such participants, including asset originators and nationally recognized statistical rating organizations ("NRSROs") who provide credit ratings on ABS issuances, the Proposed Rule is drafted as if it were the sole method of regulation and oversight of actors participating in the securitization market. This initial approach results in an overly-expansive scope of the risk retention requirements in the Proposed Rule and an overly-conservative method of defining certain exemptions and limitations mandated by the statute.

Examples of provisions in the Dodd-Frank Act designed to regulate the securitization industry are numerous and include provisions to increase the regulation and supervision of NRSROs and the transparency of credit rating methods.[8] Added oversight and transparency will greatly increase the value of such ratings and disclosures for ABS investors, a fact that is ignored in the Proposed Rule's heightened disclosure requirements for entities seeking to meet an exemption from the five percent risk retention requirement. Similarly, provisions other than Section 941 that require issuers of registered ABS to perform a review of the assets underlying the ABS and to disclose the nature of the review to investors will also provide additional market transparency.[9] Further, disclosure regarding the prior history of an ABS issuer's securitization transactions and investor or trustee requests for the repurchase of assets collateralizing the issuer's ABS provide additional transparency of the securitization process that must be acknowledged elsewhere in related rules such as the Proposed Rule.[10] Duplicative review and disclosure requirements in the Proposed Rule and these other regulations create a regulatory environment in which the burdens of compliance outweigh any benefits derived from duplicative disclosure and related obligations on market participants. Finally, such an overly-burdensome regulatory framework may have the unintended consequence of choking access to credit for individual borrowers, small businesses, large employers and others struggling to expand a fragile economic recovery at a time when credit is most needed.

Underwriting Standards – General Considerations. The Agencies must ensure that implementation of the Dodd-Frank Act does not reduce credit availability or unnecessarily increase the cost of credit to consumers. Fundamentally sound underwriting criteria is essential to ensuring that factors which contributed to the recent economic crisis are not repeated. Underwriting standards must not, however, result in a restriction of credit or imposition of artificially high interest rates for creditworthy borrowers.

Underwriting standards for qualifying asset classes should also be realistic and consistent with industry practice and historic data available for such asset classes. Credit history of a

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7 For reasons set forth more fully below, the timing for implementation of the final rule for credit risk retention should be aligned with the implementation of related amendments to the Truth in Lending Act ("TILA").

8 *See* Dodd-Frank Act, §§ 932, 935, 936, 938 and 945; *see also* 76 Fed. Reg. at 24,096.

9 *See* Dodd-Frank Act, § 945; *see also* 76 Fed. Reg. at 24,096.

10 *See* Dodd-Frank Act, § 943; *see also* 76 Fed. Reg. at 24,096.

borrower is a meaningful indicator of the likelihood of future performance of a loan and should be a consideration in credit underwriting. However, the Proposed Rule creates underwriting requirements for risk retention exemptions that are impractical and unworkable. For example, the proposed underwriting standards for exempt qualified consumer loan products require the originator to verify and document that, within 30 days of origination, the borrower was not currently 30 days or more past due, in whole or in part, on any debt obligation. This information is not currently available in any commercially reasonable fashion and, absent reliance on a representation by the borrower, would require the lender to contact each of the borrower's creditors to ensure compliance at the time of origination. We note that the safe harbor provisions for creditors obtaining two or more credit reports on the borrower within 90 days of closing and retaining of these records is not sufficient to address the practical realities of the market. In fact, not all asset classes rely on consumer reporting agencies in their underwriting. For example, the automotive finance industry generally relies on proprietary risk modeling matrices as part of their underwriting. In these instances, obtaining not one, but two, credit reports increases origination costs without a corresponding enhancement of loan performance – and these costs will, in turn, be passed along to consumers in the form of higher priced credit or less access to credit.

Additional discussions of industry-specific concerns regarding the rigidity of the Proposed Rule's underwriting standards with respect to a particular class of assets are set forth below.

Premium Capture Cash Reserve Account. Section 15G of the Exchange Act establishes a risk retention requirement of five percent for a sponsor of a securitization, subject to various exceptions. While AFSA recognizes that the Agencies have authority to require risk retention levels that differ from the general five percent requirement, AFSA does not believe that this authority should be used to impose additional requirements that go beyond risk retention and that could further impair capital formation.

The Proposed Rule's provisions requiring the establishment of premium capture cash reserve accounts do exactly that. These provisions require that any excess spread in a transaction must remain in a first loss position for the life of the transaction. This requirement is in addition to the five percent risk retention otherwise required to be retained. By so doing, the Proposed Rule significantly increases the five percent risk retention requirement, while restricting the sponsor's ability to structure its transactions in an efficient manner. These additional requirements are unnecessary in light of the general five percent risk retention requirement and go well beyond the mandate of the Dodd-Frank Act.

Excess spread, as described in the Proposed Rule, results from over-collateralization of pools backing ABS and issuance of ABS at yields lower than the aggregate yield paid to ABS investors. The monetization of the excess spread allows a sponsor to receive the anticipated value for this asset at the time of the securitization, rather than over the life of the ABS issuance. The monetization of the excess spread can be an important component of the sponsor's economic return in a securitization and is often used to defray the sponsor's costs of securitization. It represents nothing more than the market value of the asset of the sponsor represented by the excess spread.

While the Proposed Rule permits sponsors to satisfy the five percent risk retention requirement in various ways, the premium capture cash reserve account provisions depart from this more flexible approach in a particularly restrictive fashion. In effect, these provisions are nothing more than an inflexible requirement that the sponsor retain more than five percent of the risk of the securitized assets through the subordination of a very specific asset – the excess spread. It achieves no different result than requiring a sponsor to subordinate any other asset it may own to the payment of the ABS interests in excess of the general five percent requirement. In fact, the Proposed Rule itself recognizes that the premium capture cash reserve account may reduce the flexibility of sponsors in structuring the securitization, thus imposing a cost.[11] In other words, the Proposed Rule imposes a requirement to establish a premium capture cash reserve account that ignores fundamental economic realities of a securitization and increases the costs incurred by a sponsor. Such a result will undoubtedly reduce the availability of credit to U.S. consumers and businesses, particularly credit for non-prime borrowers as over-collateralization and excess spread tend to be greater in transactions involving lower credit quality assets.

The premium capture cash reserve account provisions of the Proposed Rule seem to be based on the premise that monetization of excess spread could undermine the incentive-alignment objectives of the Proposed Rule because a sponsor might be "able to recover more than five percent of the balance of the pool in a short period of time."[12] This analysis is flawed because it ignores the fact that the sponsor must comply with the primary five percent risk retention requirements of the Proposed Rule in any event. Following the Agencies' logic in proposing premium capture, one would argue that a homeowner who owns two homes and sells one at a profit no longer cares about the value of the retained home. This is obviously incorrect. The homeowner remains interested in the value of the retained home, just as a securitizer or sponsor remains interested in the value of the retained portion of the ABS issuance held on its books and in the performance of the underlying assets. Risk retention is more than adequate to ensure appropriate alignment of interests. The fact that a securitizer or sponsor is able to sell the excess spread asset for a market price does not affect risk retention.

Delaying cash flows from monetized excess spread by mandating their placement in a premium capture cash reserve account extends the time period over which the securitizer or sponsor must wait for returns, thereby reducing return on capital and increasing the costs of funding. These costs will be passed onto consumers in the form of higher rates or less access to credit.

Maintaining Retained Exposures. Mandating risk retention for the life of the ABS is punitive and does not further the purpose of aligning the interests of ABS securitizers or sponsors and ABS investors. Under the Proposed Rule, an eligible horizontal residual interest must be held "until all other ABS interests in the issuing entity are paid in full, the eligible horizontal residual interest generally cannot receive any payments of principal made on a securitized asset[,]"[13] other than a proportionate share of scheduled principal repayments as set forth in the transaction documents. Retention of a residual interest, including residual interests

[11] 76 Fed. Reg. at 24,152.
[12] 76 Fed. Reg. at 24,151.
[13] 76 Fed. Reg. at 24,102.

held under the L-shaped risk retention model or in a horizontal cash reserve account, is thus required to be held for the life of the ABS. A sponsor using the representative sample method must likewise hold the assets in the representative sample until all ABS interests are repaid.[14] AFSA believes that there is no particular value in mandating that sponsors hold risk exposures throughout the life of an ABS issuance and notes that delayed cash flows to the ABS securitizer or sponsor reduces cash flows and return on capital – further increasing the costs borne by consumers, and reducing the amount of credit available to borrowers.

Depending on asset class, a borrower generally defaults within a set period of time if he or she was not a creditworthy borrower in the first instance. No amount of underwriting can predict a change in general economic or local market conditions that may affect a borrower or class of borrowers. For example, a mortgage loan originator holding loans in a portfolio can generally expect to know whether a mortgage will perform within 36 months of origination, holding market conditions constant. Similarly, an originator of automotive finance assets can generally expect loan defaults to peak within 12 to 24 months of origination. Requiring an ABS securitizer or sponsor to comply with the risk retention requirements for the life of the ABS issuance fails to take into account these statistics with respect to asset performance. Moreover, industry and investor standards mandate that an ABS issuance be over-collateralized to ensure that any losses incurred on the underlying pool from unexpected defaults are absorbed without impacting the performance of the ABS. Rather, the Agencies should require risk retention in a period more closely aligned with the typical performance of the specific asset class to more squarely align the interests of the asset originator, ABS securitizer or sponsor with the interests of an ABS investor and reduce the impact of risk retention on credit availability or cost of credit.

The Proposed Rule's lack of flexibility in altering the form of risk retention held over time to reflect changes to the market and the seasoning of the collateral during the term of the ABS issuance further exacerbates the financial detriment to the sponsor throughout the hold period. Sponsors should be permitted to reconfigure the retained interest composition to meet changing economic conditions, provided proper disclosures about such adjustments are made in transaction documents and the retained interest always meets the specified risk retention minimum. Section 15G's statutory mandate is that a sponsor retain a fixed percentage of exposure, rather than a fixed amount, over the life of the ABS issuance. The economic difference between that mandate and the retention requirements set forth in the Proposed Rule is substantial. The Agencies should permit additional flexibility for a sponsor to hedge or dispose of a portion of the retained interest, so long as it maintains the requisite level of risk exposure.

Residential Mortgage Industry Considerations. The Dodd-Frank Act requires many changes to the manner in which residential mortgages are originated, including enhanced requirements that lenders consider a borrower's ability to repay the loan at the time of origination and establishing a safe harbor for certain "qualified mortgages." The housing market nationally is significantly burdened by increased inventory from foreclosures that are expected to continue at elevated levels for some time.[15] At a time when the national housing market is

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[14] 76 Fed. Reg. at 24,106.

[15] *See, e.g.*, Nick Timiraos, *Five Questions on Tuesday's S&P/Case-Shiller*, Wall St. J., May 31, 2011 ("Against this backdrop of anemic demand, the supply of homes is high as banks push more foreclosed properties onto the

experiencing a double dip and the overall economy is still extremely fragile,[16] the timing and aggregate effect of regulatory changes, including the Proposed Rule, needs to be carefully considered. Simply stated, this is not the right time to place more regulatory burdens on the credit market.

Timing of QRM Definition Should Mirror TILA Qualified Mortgage Rules. One important element of careful consideration is the general need for additional time to research the potential impact of regulations in decreasing the availability of credit, while also simultaneously increasing its cost to consumers. Another necessary element of careful consideration, specific to the Proposed Rule, is its definition of "qualified residential mortgage" ("QRM")and the relationship to Dodd-Frank Act's amendments to TILA and Regulation Z,[17] which defines "qualified mortgage" and provides a safe harbor or rebuttable presumption of compliance under TILA's repayment ability test for such loans.[18] By statute, the definition of QRM may be no broader than the definition of qualified mortgage.[19] Although the TILA amendments require lenders to consider a borrower's ability to repay a mortgage loan and provide the qualified mortgage definition as a proxy by which a lender can comply with this requirement, and Section 15G requires the Agencies to adopt a rule that addresses the alignment of interests between securitizers or sponsors of ABS issuances with those of ABS investors, the ultimate objective of both is the same – to increase the likelihood of performance of a mortgage loan, whether held in a portfolio by a lender or securitized and sold in the secondary market.

Based on the breadth of the issues identified in the Proposed Rule and level of regulatory overlap between the Proposed Rule's definition of QRM and the current proposal to implement the TILA amendments, the Agencies should take the opportunity to consider comments received and reissue another proposed rule and round of comments prior to implementing final risk retention requirements. Such a course of action would permit a better understanding and analysis of the impact of the combination of these rules on the residential mortgage industry, the U.S. housing market and the overall economy.

Qualified Residential Mortgage Servicing Standards. The Proposed Rule exceeds the statutory mandate of Section 15G by imposing terms that are outside the scope of both the statute's language and the legislative intent of Section 941 of the Dodd-Frank Act. Specifically, establishing mandatory servicing standards in the regulation for QRMs is inappropriate as part of the QRM definition. AFSA supports the establishment of sound servicing standards that provide clarity to the industry and align servicer and investor interests; however, using the Proposed Rule

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market.") Loans in the process of foreclosure remain "near their highest levels of the current crisis" and "the housing market badly needs job growth to improve." *Id.*

16 *See, e.g.*, Dina ElBoghdady, *Home Prices Take a Double Dip*, Wash. Post, June 1, 2011, at A12 ("The prices of single-family homes have dropped to their lowest level since 2009, creating a 'double dip' as values fell below where they were when the housing market collapsed" in 2008). Declines in single-family home prices through the first quarter of 2011 have led "analysts to conclude that prices have fallen by more than they did during the Great Depression." *Id.*

17 Dodd-Frank Act, § 1411 (to be codified at 15 U.S.C. § 1639c).

18 *See* Regulation Z; Truth in Lending, 76 Fed. Reg. 27,390 (May 11, 2011) (issuing proposed rule and request for comment on implementing changes to Regulation Z and noting that, after July 22, 2011, rulemaking will be transferred to the Consumer Financial Protection Bureau).

19 Exchange Act, § 15G(c)(4)(C).

as the vehicle to establish servicing standards is not an efficient or effective method for imposing such requirements.

This Proposed Rule is designed to ensure that risk is retained in securitization transactions and that certain mortgages are exempt from the risk retention provisions. Exempt mortgages are determined by either exemptions provided explicitly in Section 15G of the Exchange Act or by meeting the underwriting standards developed by the Agencies as part of the definition of QRM. Whether a particular mortgage loan meets the established underwriting standards can be determined with relative certainty before or at the time of origination. Thus, compliance with the Proposed Rule's underwriting standards could only be frustrated at some point after origination by unusual circumstances, for example, borrower misrepresentations or inaccurate credit reports, causing the originator to lose any protection the exemption provided.

Servicing standards can only be evaluated by reviewing the performance in the future should a loan become non-performing, a fact that is clearly not ascertainable at the time of origination. All parties dealing with a presumed QRM, therefore, would be required to recognize the lack of certainty of the designation of the mortgage as a QRM at the time of origination or securitization since compliance with the servicing standards would only be later determined during the life of the loan. This elevated level of uncertainty regarding the loan's status as a QRM raises serious questions about the practical utility of the QRM exemption itself.

Congress did not intend for the Agencies to use the Proposed Rule as the vehicle for creating uniform standards of mortgage servicing. Section 15G(e)(4)(B) of the Exchange Act directs the Agencies to define the exemption for QRMs in a manner that takes into consideration underwriting and product features that lower the risk of default. Servicing standards are not an element of underwriting, and were most likely only inserted into the Proposed Rule as a reaction to the nationwide foreclosure crisis that was heavily politicized at the time the Proposed Rule was drafted.

Loan-to-Value Ratios and Debt-to-Income. Underwriting standards for QRMs should not include either loan-to-value ratios ("LTV") or debt-to-income ratios ("DTI"). As a general matter, LTVs are not indicative of the likelihood of future borrower defaults. Setting standards based on LTVs does not impose market discipline, but rather promotes the extension of credit based on appraisal values of the underlying collateral rather than true underwriting of the creditworthiness of the borrower. Finally, and perhaps most importantly, Congress had ample opportunity to include specific reference to consideration of LTVs in the definition of QRM under Section 15G and did not do so.[20]

Underwriting standards for defining QRMs should also not include considerations of borrower DTIs. DTIs are one of the most fluid indicators of determining creditworthiness. Verification of a borrower's income ensures a relatively certain revenue stream with which the borrower can repay the residential mortgage loan. Consideration of a borrower's DTI over a period of many years also may display the portion of the revenue stream that has, on average, been available to service a mortgage. However, consideration of a snapshot of a borrower's DTI

[20] *See, e.g.*, Exchange Act, § 15G(e)(4)(B) (listing factors for consideration in establishing QRM standards to the exclusion of LTV).

at the time of origination fails to allow the flexibility necessary to consider the implications of general creditworthiness over a period of time, such as historical income patterns or past job loss. Other factors listed in the Proposed Rule, such as past borrower defaults, bankruptcy history, prior foreclosures and amounts owed that are past-due are superior and more direct indicators of the creditworthiness of a borrower.

Taken together, the current LTV and DTI requirements for QRMs in the Proposed Rule will have inconsistent results for many borrowers who are otherwise creditworthy. Some borrowers may have a great deal of equity in a house being sold and therefore may be able to meet a LTV ratio of 80 percent or less with a large down payment on a new house purchase, but have limited income streams to meet the front-end and back-end DTI ratios (such as retirees who sold a home to relocate but might have a fixed income stream as they begin retirement). Additionally, the use of DTIs have a disparate impact on low- to moderate-income families. Given these unfavorable outcomes, we believe that the Agencies should remove LTV and DTI as considerations for defining a QRM.

Credit Scores. The Agencies explicitly exclude "a credit score threshold" in the Proposed Rule's definition of QRM for a number of reasons.[21] AFSA's members generally support the Agencies' approach that a minimum credit score requirement should not be part of the QRM definition. In addition to the reasons stated by the Agencies in the Proposed Rule, another strong reason to avoid a minimum credit score threshold in defining QRM is that the risk associated with credit score values is not static; the "propensity for default" levels associated with credit scores shift over time. To illustrate the point, in the case of one credit score model, consumers whose scores ranged from 691-710 had a default rate of 5.99 percent between June 2003 and June 2005. The default rates for that same credit score range increased to 10 percent by the June 2008 to June 2010 period. As a result, imposing a minimum credit score by regulation would not treat default risk consistently. Instead, it would have the unintended consequence of ensuring that the intended risk floor would fluctuate, rather than remain stable.

If the Agencies wish to include readily ascertainable, useful metric in defining QRM, the best solution is to simply establish the maximum allowable propensity for default (rather than a credit score value), as the propensity for default level remains constant over time. Lenders are already familiar with propensity for default because credit score developers provide lenders with performance charts that show the relationship between credit score values and the associated propensity for default.

Automotive Finance Industry Considerations. As noted above, AFSA's membership includes key participants in the automotive finance industry, covering retail, dealer floorplan and fleet financing and leasing. The automotive industry has historically operated on a fundamentally different model from other lenders and does not follow the "originate to distribute" model which is credited with creating much of the misalignment of interest between originators and sponsors of ABS and investors. In fact, the automotive finance industry has not been considered to be a material contributor to the recent economic crisis. AFSA appreciates the efforts of the Agencies to recognize and take into account the heterogeneity of asset-classes and

[21] *See*, 76 Fed. Reg. at 24,121 ("the Agencies do not propose to use a credit score threshold as part of the QRM definition[.]").

securitization practices and strongly supports the use of a range of risk retention options to allow a sponsor to satisfy risk retention obligations. We also note that virtually all motor vehicle securitizers already have substantial involvement with the ABS they issue, as they originate and service the collateral that comprises the asset pool and retain risk exposure through a subordinated residual interest – however these interests do not fit the definition of eligible horizontal residual interest provided in the Proposed Rule.

AFSA's automotive finance members have identified the two options that, as presented in the Proposed Rule, are most in-line with current industry practice and market realities. These two options, the horizontal residual interest and representative sampling, need additional clarification and revision to make them appropriate and workable for securitization transactions. The Proposed Rule should also allow greater flexibility to combine different forms of risk retention in a securitization and to modify the manner in which the exposures are held over time, which would achieve the goals of risk retention while reflecting the current structures of their transactions and investors' preferences.

Horizontal Risk Retention. As noted above, automotive securitizations often involve the retention of a first-loss position by the sponsor or an affiliate that is subordinated to all other tranches of ABS issued in the transaction. The retention of this subordinated interest effectively aligns the incentives of both the ABS sponsors and the ABS investors. Like the eligible horizontal residual interest definition in the Proposed Rule, this retained interest bears the burden of losses, if any, on the underlying pool of assets until it has been fully depleted and is the most subordinated right to repayment in the transaction's waterfall of collection on the pool of assets. AFSA believes that these two characteristics alone are appropriate and sufficient to meet the Proposed Rule's incentive-aligning objectives.

However, the Proposed Rule requires that an eligible horizontal residual interest must be prohibited from receiving "any payments of principal made on securitized assets" other than "its proportionate share of scheduled payments of principal received on the securitized assets in accordance with the relevant transaction documents."[22] AFSA believes that, with respect to the automotive finance industry, the requirement that the retained interest only receive a proportionate share of scheduled payments of principal is ineffective, inefficient, and does not match current industry standards adopted to address market realities in ABS transactions. Preventing payments on the subordinated residual interest only results in the retention of more credit enhancement within the securitization than the sponsor, investors, underwriters and rating agencies had previously determined was needed to protect investors against a multiple of expected losses. Moreover, industry standards already require that payments be made only to the subordinated retained interest if all senior tranches of ABS are current and other costs and expenses associated with the transaction have been paid. In other words, industry standards permit payments to the residual interest only when the transaction is paying on schedule and generating excess collections.

Most automotive finance ABS transactions do not involve collections that are segregated into principal and interest collections and applied in separate waterfalls. Moreover, most retail automotive loans create a receivable on a "simple interest" basis without a scheduled principal

[22] 76 Fed. Reg. at 24,102.

payment. Under the simple interest method, a borrower's payment is applied to interest accrued through the date the payment is received with the remainder applied to the principal balance. Also, there is no concept of principal payments in lease financing where the lessee owes rental payments not characterized as principal or interest. Thus, defining the eligible horizontal residual interest in the proposed rule to prohibit payments to the retained interest other than from "scheduled payments of principal" on the pool assets would require that the securitizations separately track and account for interest, "regular" principal and "other" principal collections as they flow through the waterfall. Again, this is inconsistent with reporting and cash application for current automotive finance ABS and eliminates the eligible horizontal residual interest as an option for retaining the required interest in the ABS issuance.

AFSA requests that the Agencies revise the definition of eligible horizontal residual interest applicable to the automotive finance ABS sponsors to match the subordinated interest currently retained in many automotive finance ABS issuances. Specifically, the definition should not require that the subordinated interest only receive scheduled payments of principal. Instead, the Proposed Rule should allow payments to the subordinated interest so long the senior interests have received payments equal to any decrease in the assets underlying their interest.

Representative Sampling. AFSA automotive finance members appreciate the Agencies providing a representative sample option. This option is similar to the current industry practice for retaining a, sometimes significant, portfolio of similarly underwritten assets which meet the securitization pool criteria. The Proposed Rule is, however, impractical and unnecessarily cumbersome and, as currently drafted, would not likely be used by the automotive finance ABS sponsors.

Given the size of retained portfolios, sometimes ranging in the hundreds of thousands to millions of originated and serviced loans, the Proposed Rule's requirement to maintain specific loan assets with respect to a given ABS securitization is unworkable. Alternatives to this approach include the use of a revolving pool of unencumbered, retained loan assets that otherwise meets the representative sampling requirements with respect to the pool of assets collateralizing the ABS issuance set forth in the Proposed Rule. If the Agencies insist on a sponsor retaining a specifically designated pool of assets, the assets selected for the pool should be identified using the same selection criteria used to identify the loans for the pool collateralizing the ABS. The Proposed Rule's requirements that such loans be equivalent for material characteristics, both quantitatively and categorically, should be removed as impracticable in the automotive finance industry. Similarly, requirements that demand an agreed upon procedures report on the selection, testing and maintenance procedures at the time of the ABS sale, requiring monthly testing and reporting of the performance of the retained portfolio for comparison against the ABS pool are also unnecessarily costly and time consuming. The costs and resource expenditure resulting from compliance with these additional requirements for the representative sample option overwhelmingly outweigh the benefits the Proposed Rule suggests are achieved through their use – making it highly unlikely that such an alternative could or would be used by the industry.

Combinations of Risk Retention Methods. The Agencies, in developing the L-Shaped risk retention option, recognize the market utility of permitting a sponsor to meet its risk retention obligations through the combination of two or more of the other permitted menu of retention options. The Agencies should provide a method for sponsors to use combinations of the menu of risk retention options to meet the five percent risk retention requirement. Additional flexibility in this regard will reduce transaction and compliance costs and allow sponsors to meet the risk retention standard in the most efficient method.

Qualifying Automobile Loan Standards. The Proposed Rule narrowly defines the standards for qualifying automobile loans. As drafted, a great deal of the focus is on underwriting standards and loan characteristics that are more appropriately considered in the context of other asset classes. Unlike other asset classes, automotive lenders often rely on proprietary methods to evaluate and price loans and leases that are not comparable to the underwriting standards and requirements set forth in the Proposed Rule. It is not likely that any automotive finance ABS issuance has been completed in the past that would meet the requirements in the Proposed Rule for qualifying automobile loans.

The underwriting standards for qualifying automobile loans and underlying loan level definitions also fail to take into account the legal requirements and business considerations for the automotive finance industry. For example, one of the requirements for the qualifying automobile loans is that the transactions documents require that physical possession of the vehicle title be maintained by the person holding the loan until the loan is repaid in full. At least a dozen states do not permit an automotive finance company to hold physical title and another state requires that title be held by the state until the loan is fully repaid. Finally, approximately 13 states have implemented electronic title systems resulting in no physical title being issued for a vehicle. Accordingly, such a standard is inappropriate and unnecessary in ensuring that interests are aligned between ABS sponsors and ABS investors. Other examples of unworkable provisions in the underwriting standards include, among other things, (i) income and employment verification standards, which are primarily conducted on only the most marginal of credit applicants; (ii) restrictions on the term of the loan for 5 years, where 72-month terms are commonplace; and (iii) restrictions on used vehicle financing that does not reflect industry use of certified pre-owned vehicles of high quality often under extended warranties and beyond the steepest part of the depreciation curve. These standards are somewhat arbitrary, unnecessarily constrain flexibility to meet changing market conditions and do not serve as a relevant factor in aligning ABS sponsor and investor interests.

An alternative approach to the definition set forth in the Proposed Rule is to focus on the securitization's entire asset pool based upon specified pool characteristics. Automotive finance assets are generally homogeneous within their respective subclasses. As compared to other asset classes covered by the Proposed Rule, automotive finance assets are short term, less sensitive to interest rate fluctuations, rarely refinanced and collateralized by an underlying asset that is easily and quickly liquidated following repossession. These characteristics suggest that a focus on loan-by-loan origination characteristics to forecast a securitization asset pool's future performance is inappropriate. Additionally, nothing in Section 15G of the Exchange Act requires that every loan in the collateralizing pool meet the definition of a qualified automobile loan definition for the ABS sponsor to be exempt from the risk retention requirement. This supports a conclusion that pool-level, rather than loan-level, definitions are appropriate. Accordingly, the final rule should establish criteria for qualifying automotive finance assets that establishes requisite standards at the pool level.

Underwriting Standards. As was the case with underwriting standards for defining QRMs, underwriting standards for qualifying automotive loans should not include considerations of the borrower's DTI. DTI is not a key component in underwriting standards for automotive loans. Use of DTI also ignores the reality in which many borrowers prioritize automotive loan payments above other payment obligations to ensure that they keep their vehicle. Also, as noted above, a borrower's DTI is fluid and, when considering the borrower's DTI at one particular point in time fails to allow the flexibility necessary to consider the implications of other factors unrelated to the general creditworthiness of the borrower, such as emergency expenditures, that would adversely affect the borrower's DTI. Other traditional underwriting criteria are utilized by lenders in the automotive industry and have been found to be more indicative of credit quality.

Equipment and Machinery Industry Considerations. Equipment and machinery financing provides a vital source of credit to many U.S. commercial enterprises, including small businesses and farming or agricultural operations. Nonetheless, the Proposed Rule is silent as it relates to this significant segment of the market. Historically, ABS issuances backed by such equipment and machinery finance assets have performed without material losses for ABS investors, similar to historical performance for ABS issuances collateralized by automotive finance assets.[23] This strong performance is based, at least in part, on factors such as "differences in market practices and conventions, which in many instances exist for sound reasons related to the inherent nature of the type of asset being securitized."[24]

Section 15G(c)(2)(B) directs the Agencies to issue regulations which "establish asset classes with separate rules for securitizers of different classes of assets, including residential mortgages, commercial mortgages, commercial loans, auto loans, and any other class of assets" deemed appropriate by the Agencies. The Proposed Rule defines a commercial loan as a:

> [S]ecured or unsecured loan to a company or an individual for business purposes, other than any:
> (1) Loan to purchase or refinance a one-to-four family residential property;
> (2) Loan for the purpose of financing agricultural production; or
> (3) Loan for which the primary source (fifty (50) percent or more) of repayment is expected to be derived from rents collected from persons or firms that are not affiliates of the borrower.[25]

Many classes of commercial loan assets fall squarely within this definition. However, it is essential for an additional subcategory of commercial loans to be separately defined to take into account equipment and machinery finance assets. The Proposed Rule should also include appropriately defined criteria for an exclusion from risk retention requirements for qualified equipment and machinery financing assets. The definition and exclusion should establish standards that recognize the strong, historical performance of ABS issuances collateralized by

[23] *See* Board of Governors of the Federal Reserve System, *Report to the Congress on Risk Retention* p. 63 (Oct. 2010) (noting that ABS collateralized by equipment loans and leases "have displayed strong performance throughout the financial crisis" and that "the short maturity of the underlying equipment loans means that the level of credit enhancement increases over the life of the security.").

[24] *Id.* at p. 83.

[25] 76 Fed. Reg. at 24,168.

machinery and equipment finance assets and consider the industry-specific processes and standards that apply in their origination.

The definition of commercial loan and the requirements for a qualified commercial loan exemption from risk retention set forth in the Proposed Rule are focused solely on traditional commercial loan assets underlying typical collateralized loan obligations. Clarity for the equipment and machinery finance industry is necessary to ensure that this subcategory of commercial assets is not unduly burdened with respect to other commercial asset classes. As a threshold matter, however, we note that the Proposed Rule's commercial loan definition refers to loans "for the purpose of financing agricultural production[.]" Equipment and machinery finance assets often finance purchases of farm equipment used in farming operations for agricultural production. The definition of commercial loans should therefore ensure that the newly introduced subcategory for equipment and machinery finance assets used in farming and agricultural operations are not inadvertently excluded from the risk retention exemption for qualifying equipment and machinery finance assets.

AFSA's equipment and machinery finance members agree with and endorse the definition of "equipment commercial loan" and the underwriting standards for qualifying equipment commercial loans to be exempt from risk retention requirements as proposed by the American Securitization Forum in its comment letter to the Agencies dated June 10, 2011.[26]

Rigidity of Qualifying Assets Definitions. In addition to the specific considerations listed above, there is general industry concern regarding the inflexibility of the requirements for all qualifying forms of assets to be exempt from risk retention requirements. Under the Proposed Rule, a borrower's failure to meet any one of the criteria (such as LTV, DTI and past defaults on other obligations) or a creditor's failure to meet one of the safe harbors provided for compliance, would prohibit the loan from meeting the definition of a qualifying asset. This rigid application fails to take into consideration many mitigating factors that would otherwise strongly suggest that the borrower is creditworthy and that the asset should meet the qualifying standards. For example, a borrower who was 30 days past due on a credit card payment or student loan payment within 30 days of closing would not meet the definition of a qualified automotive loan – even if this was the only time such borrower had ever been past due. This absurd result was not intended by Congress. Rather, confirmation that such a late payment was an irregularity for the borrower and the borrower otherwise met standards required for a qualified automotive loan should be sufficient to exempt the loan from the risk retention requirements.

Depending on the standards finally adopted by the Agencies, flexibility can easily be built into the definitions and requirements in order for ABS issuances collateralized by qualifying assets to be exempt from the risk retention requirements. Such flexibility in these definitions would not result in a misalignment of interests between ABS sponsors and investors. Failure to adopt such flexibility would, however, unnecessarily increase costs to creditworthy

[26] Letter from Tom Deutsch, Executive Director, American Securitization Forum, to the Department of Treasury, Board of Governors of the Federal Reserve System, Securities and Exchange Commission, Office of the Comptroller of the Currency, Federal Housing Finance Agency, Federal Deposit Insurance Corporation and Department of Housing and Urban Development, at p. 128 and Ex. J (June 10, 2011) (*available at* http://www.federalreserve.gov/SECRS/2011/June/20110621/R-1411/R-1411_061011_81227_523427996167_1.pdf).

borrowers through higher rates charged on the asset and decrease the overall availability of credit to U.S. consumers.

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AFSA again thanks the Agencies for the opportunity to comment on this important topic and welcomes the opportunity to discuss further any of the issues raised in this letter. If you have any questions or if we can provide any additional information, please feel free to contact me at 202-296-5544, ext. 616 or bhimpler@afsamail.org.

Respectfully submitted,

Bill Himpler

Bill Himpler
Executive Vice President
American Financial Services Association