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Part II

Department of the Treasury

Office of the Comptroller of the Currency

Federal Reserve System

Federal Deposit Insurance Corporation

Federal Housing Finance Agency

Securities and Exchange Commission

Department of Housing and Urban  
Development

12 CFR Parts 43, 244, 373, et al.

17 CFR Part 246

24 CFR Part 267

Credit Risk Retention; Proposed Rule

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[Docket No. OCC–2013–0010]

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**DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT****24 CFR Part 267**

RIN 2501–AD53

**Credit Risk Retention**

**AGENCY:** Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); U.S. Securities and Exchange Commission (Commission); Federal Housing Finance Agency (FHFA); and Department of Housing and Urban Development (HUD).

**ACTION:** Proposed rule.

**SUMMARY:** The OCC, Board, FDIC, Commission, FHFA, and HUD (the agencies) are seeking comment on a joint proposed rule (the proposed rule, or the proposal) to revise the proposed rule the agencies published in the **Federal Register** on April 29, 2011, and to implement the credit risk retention requirements of section 15G of the Securities Exchange Act of 1934 (15 U.S.C. 78o–11), as added by section 941

of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Section 15G generally requires the securitizer of asset-backed securities to retain not less than 5 percent of the credit risk of the assets collateralizing the asset-backed securities. Section 15G includes a variety of exemptions from these requirements, including an exemption for asset-backed securities that are collateralized exclusively by residential mortgages that qualify as “qualified residential mortgages,” as such term is defined by the agencies by rule.

**DATES:** Comments must be received by October 30, 2013.

**ADDRESSES:** Interested parties are encouraged to submit written comments jointly to all of the agencies. Commenters are encouraged to use the title “Credit Risk Retention” to facilitate the organization and distribution of comments among the agencies. Commenters are also encouraged to identify the number of the specific request for comment to which they are responding.

*Office of the Comptroller of the Currency:* Because paper mail in the Washington, DC area and at the OCC is subject to delay, commenters are encouraged to submit comments by the Federal eRulemaking Portal or email, if possible. Please use the title “Credit Risk Retention” to facilitate the organization and distribution of the comments. You may submit comments by any of the following methods:

- *Federal eRulemaking Portal—“Regulations.gov”:* Go to <http://www.regulations.gov>. Enter “Docket ID OCC–2013–0010” in the Search Box and click “Search”. Results can be filtered using the filtering tools on the left side of the screen. Click on “Comment Now” to submit public comments. Click on the “Help” tab on the Regulations.gov home page to get information on using Regulations.gov.

- *Email:* [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov).

- *Mail:* Legislative and Regulatory Activities Division, Office of the Comptroller of the Currency, 400 7th Street SW., Suite 3E–218, Mail Stop 9W–11, Washington, DC 20219.

- *Fax:* (571) 465–4326.

- *Hand Delivery/Courier:* 400 7th Street SW., Suite 3E–218, Mail Stop 9W–11, Washington, DC 20219.

*Instructions:* You must include “OCC” as the agency name and “Docket Number OCC–2013–0010” in your comment. In general, OCC will enter all comments received into the docket and publish them on the Regulations.gov Web site without change, including any

business or personal information that you provide such as name and address information, email addresses, or phone numbers. Comments received, including attachments and other supporting materials, are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

You may review comments and other related materials that pertain to this proposed rulemaking by any of the following methods:

- *Viewing Comments Electronically:* Go to <http://www.regulations.gov>. Enter “Docket ID OCC–2013–0010” in the Search box and click “Search”.

Comments can be filtered by agency using the filtering tools on the left side of the screen. Click on the “Help” tab on the Regulations.gov home page to get information on using Regulations.gov, including instructions for viewing public comments, viewing other supporting and related materials, and viewing the docket after the close of the comment period.

- *Viewing Comments Personally:* You may personally inspect and photocopy comments at the OCC, 400 7th Street SW., Washington, DC. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling (202) 649–6700. Upon arrival, visitors will be required to present valid government-issued photo identification and submit to security screening in order to inspect and photocopy comments.

- *Docket:* You may also view or request available background documents and project summaries using the methods described above.

*Board of Governors of the Federal Reserve System:* You may submit comments, identified by Docket No. R–1411, by any of the following methods:

- *Agency Web site:* <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.

- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments.

- *Email:* [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov). Include the docket number in the subject line of the message.

- *Fax:* (202) 452–3819 or (202) 452–3102.

- *Mail:* Address to Robert deV. Frierson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue NW., Washington, DC 20551.

All public comments will be made available on the Board's Web site at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> as submitted, unless modified for technical reasons. Accordingly, comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, NW) between 9:00 a.m. and 5:00 p.m. on weekdays.

#### *Federal Deposit Insurance*

*Corporation:* You may submit comments, identified by RIN number, by any of the following methods:

- *Agency Web site:* <http://www.FDIC.gov/regulations/laws/federal>. Follow instructions for submitting comments on the agency Web site.

- *Email:* [Comments@FDIC.gov](mailto:Comments@FDIC.gov).

Include RIN 3064-AD74 in the subject line of the message.

- *Mail:* Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street NW., Washington, DC 20429.

- *Hand Delivery/Courier:* Guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7:00 a.m. and 5:00 p.m.

- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments.

*Instructions:* All comments will be posted without change to <http://www.fdic.gov/regulations/laws/federal>, including any personal information provided. Paper copies of public comments may be ordered from the Public Information Center by telephone at (877) 275-3342 or (703) 562-2200.

*Securities and Exchange Commission:* You may submit comments by the following method:

#### **Electronic Comments**

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or

- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-14-11 on the subject line; or

- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

#### **Paper Comments**

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549-1090

- All submissions should refer to File Number S7-14-11. This file number should be included on the subject line if email is used. To help us process and

review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

*Federal Housing Finance Agency:* You may submit your written comments on the proposed rulemaking, identified by RIN number 2590-AA43, by any of the following methods:

- *Email:* Comments to Alfred M. Pollard, General Counsel, may be sent by email at [RegComments@fhfa.gov](mailto:RegComments@fhfa.gov).

Please include "RIN 2590-AA43" in the subject line of the message.

- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments. If you submit your comment to the Federal eRulemaking Portal, please also send it by email to FHFA at [RegComments@fhfa.gov](mailto:RegComments@fhfa.gov) to ensure timely receipt by the agency. Please include "RIN 2590-AA43" in the subject line of the message.

- *U.S. Mail, United Parcel Service, Federal Express, or Other Mail Service:* The mailing address for comments is: Alfred M. Pollard, General Counsel, Attention: Comments/RIN 2590-AA43, Federal Housing Finance Agency, Constitution Center, (OGC) Eighth Floor, 400 7th Street SW., Washington, DC 20024.

- *Hand Delivery/Courier:* The hand delivery address is: Alfred M. Pollard, General Counsel, Attention: Comments/RIN 2590-AA43, Federal Housing Finance Agency, Constitution Center, (OGC) Eighth Floor, 400 7th Street SW., Washington, DC 20024. A hand-delivered package should be logged in at the Seventh Street entrance Guard Desk, First Floor, on business days between 9:00 a.m. and 5:00 p.m.

All comments received by the deadline will be posted for public inspection without change, including any personal information you provide, such as your name and address, on the FHFA Web site at <http://www.fhfa.gov>. Copies of all comments timely received will be available for public inspection and copying at the address above on government-business days between the hours of 10 a.m. and 3 p.m. at the Federal Housing Finance Agency,

Constitution Center, 400 7th Street SW., Washington, DC 20024. To make an appointment to inspect comments please call the Office of General Counsel at (202) 649-3804.

*Department of Housing and Urban Development:* Interested persons are invited to submit comments regarding this rule to the Regulations Division, Office of General Counsel, Department of Housing and Urban Development, 451 7th Street SW., Room 10276, Washington, DC 20410-0500.

Communications must refer to the above docket number and title. There are two methods for submitting public comments. All submissions must refer to the above docket number and title.

- *Submission of Comments by Mail.* Comments may be submitted by mail to the Regulations Division, Office of General Counsel, Department of Housing and Urban Development, 451 7th Street SW., Room 10276, Washington, DC 20410-0500.

- *Electronic Submission of Comments.* Interested persons may submit comments electronically through the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov). HUD strongly encourages commenters to submit comments electronically. Electronic submission of comments allows the commenter maximum time to prepare and submit a comment, ensures timely receipt by HUD, and enables HUD to make them immediately available to the public. Comments submitted electronically through the [www.regulations.gov](http://www.regulations.gov) Web site can be viewed by other commenters and interested members of the public. Commenters should follow the instructions provided on that site to submit comments electronically.

- *Note:* To receive consideration as public comments, comments must be submitted through one of the two methods specified above. Again, all submissions must refer to the docket number and title of the rule.

- *No Facsimile Comments.* Facsimile (FAX) comments are not acceptable.

- *Public Inspection of Public Comments.* All properly submitted comments and communications submitted to HUD will be available for public inspection and copying between 8 a.m. and 5 p.m. weekdays at the above address. Due to security measures at the HUD Headquarters building, an appointment to review the public comments must be scheduled in advance by calling the Regulations Division at 202-708-3055 (this is not a toll-free number). Individuals with speech or hearing impairments may access this number via TTY by calling the Federal Information Relay Service at

800-877-8339. Copies of all comments submitted are available for inspection and downloading at [www.regulations.gov](http://www.regulations.gov).

**FOR FURTHER INFORMATION CONTACT:**

*OCC:* Kevin Korzeniewski, Attorney, Legislative and Regulatory Activities Division, (202) 649-5490, Office of the Comptroller of the Currency, 400 7th Street SW., Washington, DC 20219.

*Board:* Benjamin W. McDonough, Senior Counsel, (202) 452-2036; April C. Snyder, Senior Counsel, (202) 452-3099; Brian P. Knestout, Counsel, (202) 452-2249; David W. Alexander, Senior Attorney, (202) 452-2877; or Flora H. Ahn, Senior Attorney, (202) 452-2317, Legal Division; Thomas R. Boemio, Manager, (202) 452-2982; Donald N. Gabbai, Senior Supervisory Financial Analyst, (202) 452-3358; Ann P. McKeehan, Senior Supervisory Financial Analyst, (202) 973-6903; or Sean M. Healey, Senior Financial Analyst, (202) 912-4611, Division of Banking Supervision and Regulation; Karen Pence, Assistant Director, Division of Research & Statistics, (202) 452-2342; or Nikita Pastor, Counsel, (202) 452-3667, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, 20th and C Streets NW., Washington, DC 20551.

*FDIC:* Rae-Ann Miller, Associate Director, (202) 898-3898; George Alexander, Assistant Director, (202) 898-3718; Kathleen M. Russo, Supervisory Counsel, (703) 562-2071; or Phillip E. Sloan, Counsel, (703) 562-6137, Federal Deposit Insurance Corporation, 550 17th Street NW., Washington, DC 20429.

*Commission:* Steven Gendron, Analyst Fellow; Arthur Sandel, Special Counsel; David Beaning, Special Counsel; or Katherine Hsu, Chief, (202) 551-3850, in the Office of Structured Finance, Division of Corporation Finance, U.S. Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549-3628.

*FHFA:* Patrick J. Lawler, Associate Director and Chief Economist, [Patrick.Lawler@fhfa.gov](mailto:Patrick.Lawler@fhfa.gov), (202) 649-3190; Ronald P. Sugarman, Principal Legislative Analyst, [Ron.Sugarman@fhfa.gov](mailto:Ron.Sugarman@fhfa.gov), (202) 649-3208; Phillip Millman, Principal Capital Markets Specialist, [Phillip.Millman@fhfa.gov](mailto:Phillip.Millman@fhfa.gov), (202) 649-3080; or Thomas E. Joseph, Associate General Counsel, [Thomas.Joseph@fhfa.gov](mailto:Thomas.Joseph@fhfa.gov), (202) 649-3076; Federal Housing Finance Agency, Constitution Center, 400 7th Street SW., Washington, DC 20024. The telephone number for the Telecommunications

Device for the Hearing Impaired is (800) 877-8339.

*HUD:* Michael P. Nixon, Office of Housing, Department of Housing and Urban Development, 451 7th Street SW., Room 10226, Washington, DC 20410; telephone number 202-402-5216 (this is not a toll-free number). Persons with hearing or speech impairments may access this number through TTY by calling the toll-free Federal Information Relay Service at 800-877-8339.

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**I. Introduction**

The agencies are requesting comment on a proposed rule that re-proposes with modifications a previously proposed rule to implement the requirements of section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act, or Dodd-Frank Act).<sup>1</sup> Section 15G of the Exchange Act, as added by section 941(b) of the Dodd-Frank Act, generally requires the Board, the FDIC, the OCC (collectively, referred to as the Federal banking agencies), the Commission, and, in the case of the securitization of any “residential mortgage asset,” together with HUD and FHFA, to jointly prescribe regulations that (i) require a securitizer to retain not less than 5 percent of the credit risk of any asset that the securitizer, through the issuance of an asset-backed security (ABS), transfers, sells, or conveys to a third party, and (ii) prohibit a

<sup>1</sup> Public Law 111-203, 124 Stat. 1376 (2010). Section 941 of the Dodd-Frank Act amends the Securities Exchange Act of 1934 (the Exchange Act) and adds a new section 15G of the Exchange Act. 15 U.S.C. 78o-11.

securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain under section 15G and the agencies' implementing rules.<sup>2</sup>

Section 15G of the Exchange Act exempts certain types of securitization transactions from these risk retention requirements and authorizes the agencies to exempt or establish a lower risk retention requirement for other types of securitization transactions. For example, section 15G specifically provides that a securitizer shall not be required to retain any part of the credit risk for an asset that is transferred, sold, or conveyed through the issuance of ABS by the securitizer, if all of the assets that collateralize the ABS are qualified residential mortgages (QRMs), as that term is jointly defined by the agencies.<sup>3</sup> In addition, section 15G provides that a securitizer may retain less than 5 percent of the credit risk of commercial mortgages, commercial loans, and automobile loans that are transferred, sold, or conveyed through the issuance of ABS by the securitizer if the loans meet underwriting standards established by the Federal banking agencies.<sup>4</sup>

In April 2011, the agencies published a joint notice of proposed rulemaking that proposed to implement section 15G of the Exchange Act (original proposal).<sup>5</sup> The proposed rule revises the original proposal, as described in more detail below.

Section 15G allocates the authority for writing rules to implement its provisions among the agencies in various ways. As a general matter, the agencies collectively are responsible for adopting joint rules to implement the risk retention requirements of section 15G for securitizations that are backed by residential mortgage assets and for defining what constitutes a QRM for purposes of the exemption for QRM-backed ABS.<sup>6</sup> The Federal banking agencies and the Commission, however, are responsible for adopting joint rules that implement section 15G for securitizations backed by all other types of assets,<sup>7</sup> and are authorized to adopt rules in several specific areas under section 15G.<sup>8</sup> In addition, the Federal

banking agencies are jointly responsible for establishing, by rule, the underwriting standards for non-QRM residential mortgages, commercial mortgages, commercial loans, and automobile loans that would qualify ABS backed by these types of loans for a risk retention requirement of less than 5 percent.<sup>9</sup> Accordingly, when used in this Notice of Proposed Rulemaking, the term "agencies" shall be deemed to refer to the appropriate agencies that have rulewriting authority with respect to the asset class, securitization transaction, or other matter discussed.

For ease of reference, the re-proposed rules of the agencies are referenced using a common designation of § \_\_.1 to § \_\_.21 (excluding the title and part designations for each agency). With the exception of HUD, each agency will codify the rules, when adopted in final form, within each of their respective titles of the Code of Federal Regulations.<sup>10</sup> Section \_\_.1 of each agency's rule identifies the entities or transactions subject to such agency's rule.

The preamble to the original proposal described the agencies' intention to jointly approve any written interpretations, written responses to requests for no-action letters and general counsel opinions, or other written interpretive guidance (written interpretations) concerning the scope or terms of section 15G of the Exchange Act and the final rules issued thereunder that are intended to be relied on by the public generally. The agencies also intended for the appropriate agencies to jointly approve any exemptions, exceptions, or adjustments to the final rules. For these purposes, the phrase "appropriate agencies" refers to the agencies with rulewriting authority for the asset class, securitization transaction, or other matter addressed by the interpretation,

(b)(1)(G)(ii) (relating to additional exemptions for assets issued or guaranteed by the United States or an agency of the United States); (d) (relating to the allocation of risk retention obligations between a securitizer and an originator); and (e)(1) (relating to additional exemptions, exceptions or adjustments for classes of institutions or assets).

<sup>9</sup> See *id.* at section 780–11(b)(2)(B).

<sup>10</sup> Specifically, the agencies propose to codify the rules as follows: 12 CFR part 43 (OCC); 12 CFR part 244 (Regulation RR) (Board); 12 CFR part 373 (FDIC); 12 CFR part 246 (Commission); 12 CFR part 1234 (FHFA). As required by section 15G, HUD has jointly prescribed the proposed rules for a securitization that is backed by any residential mortgage asset and for purposes of defining a qualified residential mortgage. Because the proposed rules would exempt the programs and entities under HUD's jurisdiction from the requirements of the proposed rules, HUD does not propose to codify the rules into its title of the CFR at the time the rules are adopted in final form.

guidance, exemption, exception, or adjustment.

Consistent with section 15G of the Exchange Act, the risk retention requirements would become effective, for securitization transactions collateralized by residential mortgages, one year after the date on which final rules are published in the **Federal Register**, and two years after that date for any other securitization transaction.

#### A. Background

As the agencies observed in the preamble to the original proposal, the securitization markets are an important link in the chain of entities providing credit to U.S. households and businesses, and state and local governments.<sup>11</sup> When properly structured, securitization provides economic benefits that can lower the cost of credit to households and businesses.<sup>12</sup> However, when incentives are not properly aligned and there is a lack of discipline in the credit origination process, securitization can result in harmful consequences to investors, consumers, financial institutions, and the financial system.

During the financial crisis, securitization transactions displayed significant vulnerabilities to informational and incentive problems among various parties involved in the process.<sup>13</sup> Investors did not have access to the same information about the assets collateralizing ABS as other parties in the securitization chain (such as the sponsor of the securitization transaction or an originator of the securitized loans).<sup>14</sup> In addition, assets were resecuritized into complex instruments, such as collateralized debt obligations (CDOs) and CDOs-squared, which made it difficult for investors to discern the

<sup>11</sup> Securitization may reduce the cost of funding, which is accomplished through several different mechanisms. For example, firms that specialize in originating new loans and that have difficulty funding existing loans may use securitization to access more-liquid capital markets for funding. In addition, securitization can create opportunities for more efficient management of the asset-liability duration mismatch generally associated with the funding of long-term loans, for example, with short-term bank deposits. Securitization also allows the structuring of securities with differing maturity and credit risk profiles from a single pool of assets that appeal to a broad range of investors. Moreover, securitization that involves the transfer of credit risk allows financial institutions that primarily originate loans to particular classes of borrowers, or in particular geographic areas, to limit concentrated exposure to these idiosyncratic risks on their balance sheets.

<sup>12</sup> *Report to the Congress on Risk Retention*, Board of Governors of the Federal Reserve System, at 8 (October 2010), available at <http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf> (Board Report).

<sup>13</sup> See Board Report at 8–9.

<sup>14</sup> See S. Rep. No. 111–176, at 128 (2010).

<sup>2</sup> See 15 U.S.C. 780–11(b), (c)(1)(A) and (c)(1)(B)(ii).

<sup>3</sup> See 15 U.S.C. 780–11(c)(1)(C)(iii), (e)(4)(A) and (B).

<sup>4</sup> See *id.* at section 780–11(c)(1)(B)(ii) and (2).

<sup>5</sup> Credit Risk Retention; Proposed Rule, 76 FR 24090 (April 29, 2011) (Original Proposal).

<sup>6</sup> See *id.* at section 780–11(b)(2), (e)(4)(A) and (B).

<sup>7</sup> See *id.* at section 780–11(b)(1).

<sup>8</sup> See, e.g. *id.* at sections 780–11(b)(1)(E) (relating to the risk retention requirements for ABS collateralized by commercial mortgages);

true value of, and risks associated with, an investment in the securitization.<sup>15</sup> Moreover, some lenders using an “originate-to-distribute” business model loosened their underwriting standards knowing that the loans could be sold through a securitization and retained little or no continuing exposure to the loans.<sup>16</sup>

Congress intended the risk retention requirements added by section 15G to help address problems in the securitization markets by requiring that securitizers, as a general matter, retain an economic interest in the credit risk of the assets they securitize. By requiring that the securitizer retain a portion of the credit risk of the assets being securitized, the requirements of section 15G provide securitizers an incentive to monitor and ensure the quality of the assets underlying a securitization transaction, and, thus, help align the interests of the securitizer with the interests of investors. Additionally, in circumstances where the assets collateralizing the ABS meet underwriting and other standards that help to ensure the assets pose low credit risk, the statute provides or permits an exemption.<sup>17</sup>

Accordingly, the credit risk retention requirements of section 15G are an important part of the legislative and regulatory efforts to address weaknesses and failures in the securitization process and the securitization markets. Section 15G complements other parts of the Dodd-Frank Act intended to improve the securitization markets. Such other parts include provisions that strengthen the regulation and supervision of national recognized statistical rating organizations (NRSROs) and improve the transparency of credit ratings;<sup>18</sup> provide for issuers of registered ABS offerings to perform a review of the assets underlying the ABS and disclose the nature of the review;<sup>19</sup> and require issuers of ABS to disclose the history of the requests they received and repurchases they made related to their outstanding ABS.<sup>20</sup>

### *B. Overview of the Original Proposal and Public Comment*

In developing the original proposal, the agencies took into account the diversity of assets that are securitized, the structures historically used in

securitizations, and the manner in which securitizers<sup>21</sup> have retained exposure to the credit risk of the assets they securitize.<sup>22</sup> The original proposal provided several options from which sponsors could choose to meet section 15G’s risk retention requirements, including, for example, retention of a 5 percent “vertical” interest in each class of ABS interests issued in the securitization, retention of a 5 percent “horizontal” first-loss interest in the securitization, and other options designed to reflect the way in which market participants have historically structured credit card receivable and asset-backed commercial paper conduit securitizations. The original proposal also included a special “premium capture” mechanism designed to prevent a sponsor from structuring a securitization transaction in a manner that would allow the sponsor to offset or minimize its retained economic exposure to the securitized assets by monetizing the excess spread created by the securitization transaction.

The original proposal also included disclosure requirements that were specifically tailored to each of the permissible forms of risk retention. The disclosure requirements were an integral part of the original proposal because they would have provided investors with pertinent information concerning the sponsor’s retained interests in a securitization transaction, such as the amount and form of interest retained by sponsors.

As required by section 15G, the original proposal provided a complete exemption from the risk retention requirements for ABS that are collateralized solely by QRM and established the terms and conditions under which a residential mortgage would qualify as a QRM. In developing the proposed definition of a QRM, the agencies considered the terms and purposes of section 15G, public input, and the potential impact of a broad or narrow definition of QRM on the housing and housing finance markets. In addition, the agencies developed the QRM proposal to be consistent with the

requirement of section 15G that the definition of a QRM be “no broader than” the definition of a “qualified mortgage” (QM), as the term is defined under section 129C(b)(2) of the Truth in Lending Act (TILA) (15 U.S.C. 1639C(b)(2)), as amended by the Dodd-Frank Act,<sup>23</sup> and regulations adopted thereunder.<sup>24</sup>

The original proposal would generally have prohibited QRMs from having product features that were observed to contribute significantly to the high levels of delinquencies and foreclosures since 2007. These included features permitting negative amortization, interest-only payments, or significant interest rate increases. The QRM definition in the original proposal also included other underwriting standards associated with lower risk of default, including a down payment requirement of 20 percent in the case of a purchase transaction, maximum loan-to-value ratios of 75 percent on rate and term refinance loans and 70 percent for cash-out refinance loans, as well as credit history criteria (or requirements). The QRM standard in the original proposal also included maximum front-end and back-end debt-to-income ratios. As explained in the original proposal, the agencies intended for the QRM proposal to reflect very high quality underwriting standards, and the agencies expected that a large market for non-QRM loans would continue to exist, providing ample liquidity to mortgage lenders.

Consistent with the statute, the original proposal also provided that sponsors would not have to hold risk retention for securitized commercial, commercial real estate, and automobile loans that met proposed underwriting

<sup>23</sup> See 15 U.S.C. 780–11(e)(4)(C). As adopted, the text of section 15G(e)(4)(C) cross-references section 129C(c)(2) of TILA for the definition of a QM. However, section 129C(b)(2), and not section 129C(c)(2), of TILA contains the definition of a “qualified mortgage.” The legislative history clearly indicates that the reference in the statute to section 129C(c)(2) of TILA (rather than section 129C(b)(2) of TILA) was an inadvertent technical error. See 156 *Cong. Rec.* S5929 (daily ed. July 15, 2010) (statement of Sen. Christopher Dodd) (“The [conference] report contains the following technical errors: the reference to ‘section 129C(c)(2)’ in subsection (e)(4)(C) of the new section 15G of the Securities and Exchange Act, created by section 941 of the [Dodd-Frank Act] should read ‘section 129C(b)(2).’ In addition, the references to ‘subsection’ in paragraphs (e)(4)(A) and (e)(5) of the newly created section 15G should read ‘section.’ We intend to correct these in future legislation.”).

<sup>24</sup> See 78 FR 6408 (January 30, 2013), as amended by 78 FR 35430 (June 12, 2013). These two final rules were preceded by a proposed rule defining QM, issued by the Board and published in the *Federal Register*. See 76 FR 27390 (May 11, 2011). The Board had initial responsibility for administration and oversight of TILA prior to transfer to the Consumer Financial Protection Bureau.

<sup>15</sup> See *id.*

<sup>16</sup> See *id.*

<sup>17</sup> See 15 U.S.C. 780–11(c)(1)(B)(ii), (e)(1)–(2).

<sup>18</sup> See, e.g., sections 932, 935, 936, 938, and 943 of the Dodd-Frank Act (15 U.S.C. 780–7, 780–8).

<sup>19</sup> See section 945 of the Dodd-Frank Act (15 U.S.C. 77g).

<sup>20</sup> See section 943 of the Dodd-Frank Act (15 U.S.C. 780–7).

<sup>21</sup> As discussed in the original proposal and further below, the agencies propose that a “sponsor,” as defined in a manner consistent with the definition of that term in the Commission’s Regulation AB, would be a “securitizer” for the purposes of section 15G.

<sup>22</sup> Both the language and legislative history of section 15G indicate that Congress expected the agencies to be mindful of the heterogeneity of securitization markets. See, e.g., 15 U.S.C. 780–11(c)(1)(E), (c)(2), (e); S. Rep. No. 111–76, at 130 (2010) (“The Committee believes that implementation of risk retention obligations should recognize the differences in securitization practices for various asset classes.”).

standards that incorporated features and requirements historically associated with very low credit risk in those asset classes.

With respect to securitization transactions sponsored by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (jointly, the Enterprises), the agencies proposed to recognize the 100 percent guarantee of principal and interest payments by the Enterprises on issued securities as meeting the risk retention requirement. However, this recognition would only remain in effect for as long as the Enterprises operated under the conservatorship or receivership of FHFA with capital support from the United States.

In response to the original proposal, the agencies received comments from over 10,500 persons, institutions, or groups, including nearly 300 unique comment letters. The agencies received a significant number of comments regarding the appropriate amount and measurement of risk retention. Many commenters generally supported the proposed menu-based approach of providing sponsors flexibility to choose from a number of permissible forms of risk retention, although several argued for more flexibility in selecting risk retention options, including using multiple options simultaneously. Comments on the disclosure requirements in the original proposal were limited.

Many commenters expressed significant concerns with the proposed standards for horizontal risk retention and the premium capture cash reserve account (PCCRA), which were intended to ensure meaningful risk retention. Many commenters asserted that these proposals would lead to significantly higher costs for sponsors, possibly discouraging them from engaging in new securitization transactions. However, some commenters supported the PCCRA concept, arguing that the more restrictive nature of the account would be offset by the requirement's contribution to more conservative underwriting practices.

Other commenters expressed concerns with respect to standards in the original proposal for specific asset classes, such as the proposed option for third-party purchasers to hold risk retention in commercial mortgage-backed securitizations instead of sponsors (as contemplated by section 15G). Many commenters also expressed concern about the underwriting standards for non-residential asset classes, generally criticizing them as too conservative to be utilized effectively by

sponsors. Several commenters criticized application of the original proposal to managers of certain collateralized loan obligation (CLO) transactions and argued that the original proposal would lead to more concentration in the industry and reduce access to credit for many businesses.

An overwhelming majority of commenters criticized the agencies' proposed QRM standard. Many of these commenters asserted that the proposed definition of QRM, particularly the 20 percent down payment requirement, would significantly increase the costs of credit for most home buyers and restrict access to credit. Some of these commenters asserted that the proposed QRM standard would become a new "government-approved" standard, and that lenders would be reluctant to originate mortgages that did not meet the standard. Commenters also argued that this proposed standard would make it more difficult to reduce the participation of the Enterprises in the mortgage market. Commenters argued that the proposal was inconsistent with legislative intent and strongly urged the agencies to eliminate the down payment requirement, make it substantially smaller, or allow private mortgage insurance to substitute for the requirement within the QRM standard. Commenters also argued that the agencies should align the QRM definition with the definition of QM, as implemented by the Consumer Financial Protection Bureau (CFPB).<sup>25</sup>

Various commenters also criticized the agencies' proposed treatment of the Enterprises. A commenter asserted that the agencies' recognition of the Enterprises' guarantee as retained risk (while in conservatorship or receivership with capital support from the United States) would impede the policy goal of reducing the role of the Enterprises and the government in the mortgage securitization market and encouraging investment in private residential mortgage securitizations. A number of other commenters, however, supported the proposed approach for the Enterprises.

The preamble to the original proposal described the agencies' intention to jointly approve certain types of written interpretations concerning the scope of section 15G and the final rules issued thereunder. Several commenters on the original proposal expressed concern about the agencies' processes for issuing written interpretations jointly and the

possible uncertainty about the rules that may arise due to this process.

The agencies have endeavored to provide specificity and clarity in the proposed rule to avoid conflicting interpretations or uncertainty. In the future, if the heads of the agencies determine that further guidance would be beneficial for market participants, they may jointly publish interpretive guidance documents, as the federal banking agencies have done in the past. In addition, the agencies note that market participants can, as always, seek guidance concerning the rules from their primary federal banking regulator or, if such market participant is not a depository institution or a government-sponsored enterprise, the Commission. In light of the joint nature of the agencies' rule writing authority, the agencies continue to view the consistent application of the final rule as a benefit and intend to consult with each other when adopting staff interpretations or guidance on the final rule that would be shared with the public generally. The agencies are considering whether to require that such staff interpretations and guidance be jointly issued by the agencies with rule writing authority and invite comment.<sup>26</sup>

The specific provisions of the original proposal and public comments received thereon are discussed in further detail below.

### C. Overview of the Proposed Rule

The agencies have carefully considered the many comments received on the original proposal as well as engaged in further analysis of the securitization and lending markets in light of the comments. As a result, the agencies believe it would be appropriate to modify several important aspects of the original proposal and are issuing a new proposal incorporating these modifications. The agencies have concluded that a new proposal would give the public the opportunity to review and provide comment on the agencies' revised design of the risk retention regulatory framework and assist the agencies in determining whether the revised framework is appropriately structured.

The proposed rule takes account of the comments received on the original proposal. In developing the proposed

<sup>25</sup> These items would not include interpretation and guidance in staff comment letters and other staff guidance directed to specific institutions that is not intended to be relied upon by the public generally. Nor would it include interpretations and guidance contained in administrative or judicial enforcement proceedings by the agencies, or in an agency report of examination or inspection or similar confidential supervisory correspondence.

<sup>25</sup> See 78 FR 6407 (January 30, 2013), as amended by 78 FR 35429 (June 12, 2013) and 78 FR 44686 (July 24, 2013).

rule, the agencies consistently have sought to ensure that the amount of credit risk required of a sponsor would be meaningful, consistent with the purposes of section 15G. The agencies have also sought to minimize the potential for the proposed rule to negatively affect the availability and costs of credit to consumers and businesses.

As described in detail below, the proposed rule would significantly increase the degree of flexibility that sponsors would have in meeting the risk retention requirements of section 15G. For example, the proposed rule would permit a sponsor to satisfy its obligation by retaining any combination of an “eligible vertical interest” and an “eligible horizontal residual interest” to meet the 5 percent minimum requirement. The agencies are also proposing that horizontal risk retention be measured by fair value, reflecting market practice, and are proposing a more flexible treatment for payments to a horizontal risk retention interest than that provided in the original proposal. In combination with these changes, the agencies propose to remove the PCCRA requirement.<sup>27</sup> The agencies have incorporated proposed standards for the expiration of the hedging and transfer restrictions and proposed new exemptions from risk retention for certain resecuritizations, seasoned loans, and certain types of securitization transactions with low credit risk. In addition, the agencies propose a new risk retention option for CLOs that is similar to the allocation to originator concept proposed for sponsors generally.

Furthermore, the agencies are proposing revised standards with respect to risk retention by a third-party purchaser in commercial mortgage-backed securities (CMBS) transactions and an exemption that would permit transfer (by a third-party purchaser or sponsor) of a horizontal interest in a CMBS transaction after five years, subject to standards described below.

The agencies have carefully considered the comments received on the QRM standard in the original proposal as well as various ongoing developments in the mortgage markets, including mortgage regulations. For the reasons discussed more fully below, the agencies are proposing to revise the QRM definition in the original proposal to equate the definition of a QRM with

the definition of QM adopted by the CFPB.<sup>28</sup>

The agencies invite comment on all aspects of the proposed rule, including comment on whether any aspects of the original proposal should be adopted in the final rule. Please provide data and explanations supporting any positions offered or changes suggested.

## II. General Definitions and Scope

### A. Overview of Significant Definitions in the Original Proposal and Comments

#### 1. Asset-Backed Securities, Securitization Transactions, and ABS Interests

The original proposal provided that the proposed risk retention requirements would have applied to sponsors in securitizations that involve the issuance of “asset-backed securities” and defined the terms “asset-backed security” and “asset” consistent with the definitions of those terms in the Exchange Act. The original proposal noted that section 15G does not appear to distinguish between transactions that are registered with the Commission under the Securities Act of 1933 (the Securities Act) and those that are exempt from registration under the Securities Act. It further noted that the proposed definition of ABS, which would have been broader than that of the Commission’s Regulation AB,<sup>29</sup> included securities that are typically sold in transactions that are exempt from registration under the Securities Act, such as CDOs and securities issued or guaranteed by an Enterprise. As a result, the proposed risk retention requirements would have applied to securitizers of ABS offerings regardless of whether the offering was registered with the Commission under the Securities Act.

Under the original proposal, risk retention requirements would have applied to the securitizer in each “securitization transaction,” defined as a transaction involving the offer and sale of ABS by an issuing entity. The original proposal also explained that the term “ABS interest” would refer to all types of interests or obligations issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest, or residual interest, but would not include interests, such as common or preferred stock, in an issuing entity that are issued primarily to evidence ownership of the issuing entity, and the payments,

if any, which are not primarily dependent on the cash flows of the collateral held by the issuing entity.

With regard to these three definitions, some commenters were critical of what they perceived to be the overly broad scope of the terms and advocated for express exemptions or exclusions from their application. Some commenters expressed concern that the definition of “asset-backed securities” could be read to be broader than intended and requested clarification as to the precise contours of the definition. For example, certain commenters were concerned that the proposed ABS definition could unintentionally include securities that do not serve the same purpose or present the same set of risks as “asset-backed securities,” such as securities which are, either directly or through a guarantee, full-recourse corporate obligations of a creditworthy entity that is not a special-purpose vehicle (SPV), but are also secured by a pledge of financial assets. Other commenters suggested that the agencies provide a bright-line safe harbor that defines conditions under which risk retention is not required even if a security is collateralized by self-liquidating assets and advocated that certain securities be expressly excluded from the proposed rule’s definition of ABS.

Similarly, a number of commenters requested clarification with regard to the scope of the definition of “ABS interest,” stating that its broad definition could potentially capture a number of items not traditionally considered “interests” in a securitization, such as non-economic residual interests, servicing and special servicing fees, and amounts payable by the issuing entity under a derivatives contract. With regard to the definition of “securitization transaction,” a commenter recommended that transactions undertaken solely to manage financial guarantee insurance related to the underlying obligations not be considered “securitizations.”

#### 2. Securitizer, Sponsor, and Depositor

Section 15G stipulates that its risk retention requirements be applied to a “securitizer” of an ABS and, in turn, that a securitizer is both an issuer of an ABS or a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate or issuer. The original proposal noted that the second prong of this definition is substantially identical to the definition of a “sponsor” of a securitization transaction in the

<sup>27</sup> The proposal would also eliminate the “representative sample” option, which commenters had argued would be impractical.

<sup>28</sup> See 78 FR 6407 (January 30, 2013), as amended by 78 FR 35429 (June 12, 2013) and 78 FR 44686 (July 24, 2013).

<sup>29</sup> See 17 CFR 229.1100 through 17 CFR 229.1123.

Commission's Regulation AB.<sup>30</sup> Accordingly, the original proposal would have defined the term "sponsor" in a manner consistent with the definition of that term in the Commission's Regulation AB.<sup>31</sup>

Other than issues concerning CLOs, which are discussed in Part III.B.7 of this Supplementary Information, comments with regard to these terms were generally limited to requests that the final rules provide that certain specified persons—such as underwriting sales agents—be expressly excluded from the definition of securitizer or sponsor for the purposes of the risk retention requirements.

### 3. Originator

The original proposal would have defined the term "originator" in the same manner as section 15G, namely, as a person who, through the extension of credit or otherwise, creates a financial asset that collateralizes an ABS, and sells the asset directly or indirectly to a securitizer (*i.e.*, a sponsor or depositor). The original proposal went on to note that because this definition refers to the person that "creates" a loan or other receivable, only the original creditor under a loan or receivable—and not a subsequent purchaser or transferee—would have been an originator of the loan or receivable for purposes of section 15G.

### 4. Securitized Assets, Collateral

The original proposal referred to the assets underlying a securitization transaction as the "securitized assets," meaning assets that are transferred to the SPV that issues the ABS interests and that stand as collateral for those ABS interests. "Collateral" would be defined as the property that provides the cash flow for payment of the ABS interests issued by the issuing entity. Taken together, these definitions were meant to suggest coverage of the loans, leases, or similar assets that the depositor places into the issuing SPV at the inception of the transaction, though it would have also included other assets such as pre-funded cash reserve

accounts. Commenters pointed out that, in addition to this property, the issuing entity may hold other assets. For example, the issuing entity may acquire interest rate derivatives to convert floating rate interest income to fixed rate, or the issuing entity may accrete cash or other liquid assets in reserve funds that accumulate cash generated by the securitized assets. As another example, commenters noted that an asset-backed commercial paper conduit may hold a liquidity guarantee from a bank on some or all of its securitized assets.

### B. Proposed General Definitions

The agencies have carefully considered all of the comments raised with respect to the general definitions of the original proposal. The agencies do not believe that significant changes to these definitions are necessary and, accordingly, are proposing to maintain the general definitions in substantially the same form as they were presented in the original proposal, with one exception.<sup>32</sup>

To describe the additional types of property that could be held by an issuing entity, the agencies are proposing a definition of "servicing assets," which would be any rights or other assets designed to assure the servicing, timely payment, or timely distribution of proceeds to security holders, or assets related or incidental to purchasing or otherwise acquiring and holding the issuing entity's securitized assets. These may include cash and cash equivalents, contract rights, derivative agreements of the issuing entity used to hedge interest rate and foreign currency risks, or the collateral underlying the securitized assets. As noted in the rule text, it also includes proceeds of assets collateralizing the securitization transactions, whether in the form of voluntary payments from obligors on the assets or otherwise (such as liquidation proceeds). The agencies are proposing this definition in order to ensure that the provisions of the proposal appropriately accommodate the need, in administering a securitization transaction on an ongoing basis, to hold various assets other than the loans or similar assets that are transferred into the asset pool by the securitization depositor. The proposed definition is similar to elements of the definition of "eligible assets" in Rule

3a–7 under the Investment Company Act of 1940, which specifies conditions under which the issuer of non-redeemable fixed-income securities backed by self-liquidating financial assets will not be deemed to be an investment company.

To facilitate the agencies revised proposal for the QRM definition, the agencies are proposing to define the term "residential mortgage" by reference to the definition of "covered transaction" to be found in the CFPB's Regulation Z.<sup>33</sup> Accordingly, for purposes of the proposed rule, a residential mortgage would mean a consumer credit transaction that is secured by a dwelling, as such term is also defined in Regulation Z<sup>34</sup> (including any real property attached to a dwelling) and any transaction that is exempt from the definition of "covered transaction" under the CFPB's Regulation Z.<sup>35</sup> Therefore, the term "residential mortgage" would include home equity lines of credit, reverse mortgages, mortgages secured by interests in timeshare plans, and temporary loans. By defining residential mortgage in this way, the agencies seek to ensure that relevant definitions in the proposed rule and in the CFPB's rules on and related to QM are harmonized to reduce compliance burden and complexity, and the potential for conflicting definitions and interpretations where the proposed rule and the QM standard intersect. Additionally, the agencies are proposing to include those loans excluded from the definition of "covered transaction" in the definition of "residential mortgage" for purposes of risk retention so that those categories of loans would be subject to risk retention requirements that are applied to residential mortgage securitizations under the proposed rule.

## III. General Risk Retention Requirement

### A. Minimum Risk Retention Requirement

Section 15G of the Exchange Act generally requires that the agencies jointly prescribe regulations that require a securitizer to retain not less than 5 percent of the credit risk for any asset that the securitizer, through the issuance of an ABS, transfers, sells, or conveys to a third party, unless an exemption from the risk retention requirements for the securities or transaction is otherwise available (*e.g.*, if the ABS is collateralized exclusively

<sup>30</sup> See Item 1101 of the Commission's Regulation AB (17 CFR 229.1101) (defining a sponsor as "a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.").

<sup>31</sup> As discussed in the original proposal, when used in the federal securities laws, the term "issuer" may have different meanings depending on the context in which it is used. For the purposes of section 15G, the original proposal provided that the agencies would have interpreted an "issuer" of an asset-back security to refer to the "depositor" of an ABS, consistent with how that term has been defined and used under the federal securities laws in connection with an ABS.

<sup>32</sup> Regarding comments about what securities constitutes an ABS interest under the proposed definition, the agencies preliminarily believe that non-economic residual interests would constitute ABS interests. However, as the proposal makes clear, fees for services such as servicing fees would not fall under the definition of an ABS interest.

<sup>33</sup> See 78 FR 6584 (January 30, 2013), to be codified at 12 CFR 1026.43.

<sup>34</sup> 12 CFR 1026.2(a)(19).

<sup>35</sup> *Id.*

by QRMs). Consistent with the statute, the original proposal generally required that a sponsor retain an economic interest equal to at least 5 percent of the aggregate credit risk of the assets collateralizing an issuance of ABS (the base risk retention requirement). Under the original proposal, the base risk retention requirement would have applied to all securitization transactions that are within the scope of section 15G, regardless of whether the sponsor were an insured depository institution, a bank holding company or subsidiary thereof, a registered broker-dealer, or other type of entity.<sup>36</sup>

The agencies requested comment on whether the minimum 5 percent risk retention requirement was appropriate or whether a higher risk retention requirement should be established. Several commenters expressed support for the minimum 5 percent risk retention requirement, with some commenters supporting a higher risk retention requirement. However, other commenters suggested tailoring the risk retention requirement to the specific risks of distinct asset classes.

Consistent with the original proposal, the proposed rule would apply a minimum 5 percent base risk retention requirement to all securitization transactions that are within the scope of section 15G, regardless of whether the sponsor is an insured depository institution, a bank holding company or subsidiary thereof, a registered broker-dealer, or other type of entity, and regardless of whether the sponsor is a supervised entity.<sup>37</sup> The agencies continue to believe that this exposure should provide a sponsor with an incentive to monitor and control the underwriting of assets being securitized and help align the interests of the sponsor with those of investors in the ABS. In addition, the sponsor also would be prohibited from hedging or otherwise transferring its retained interest prior to the applicable sunset

<sup>36</sup> Synthetic securitizations and securitizations that meet the requirements of the foreign safe harbor are examples of securitization transactions that are not within the scope of section 15G.

<sup>37</sup> See proposed rule at §§ \_\_.3 through \_\_.10. Similar to the original proposal, the proposed rule, in some instances, would permit a sponsor to allow another person to retain the required amount of credit risk (e.g., originators, third-party purchasers in commercial mortgage-backed securities transactions, and originator-sellers in asset-backed commercial paper conduit securitizations). However, in such circumstances, the proposal includes limitations and conditions designed to ensure that the purposes of section 15G continue to be fulfilled. Further, even when a sponsor would be permitted to allow another person to retain risk, the sponsor would still remain responsible under the rule for compliance with the risk retention requirements.

date, as discussed in Part III.D of this **SUPPLEMENTARY INFORMATION.**

The agencies note that the base risk retention requirement under the proposed rule would be a regulatory minimum. The sponsor, originator, or other party to a securitization may retain additional exposure to the credit risk of assets that the sponsor, originator, or other party helps securitize beyond that required by the proposed rule, either on its own initiative or in response to the demands or requirements of private market participants.

#### *B. Permissible Forms of Risk Retention—Menu of Options*

Section 15G expressly provides the agencies the authority to determine the permissible forms through which the required amount of risk retention must be held.<sup>38</sup> Accordingly, the original proposal provided sponsors with multiple options to satisfy the risk retention requirements of section 15G. The flexibility provided in the original proposal's menu of options for complying with the risk retention requirement was designed to take into account the heterogeneity of securitization markets and practices and to reduce the potential for the proposed rules to negatively affect the availability and costs of credit to consumers and businesses. The menu of options approach was designed to be consistent with the various ways in which a sponsor or other entity, in historical market practices, may have retained exposure to the credit risk of securitized assets.<sup>39</sup> Historically, whether or how a sponsor retained exposure to the credit risk of the assets it securitized was determined by a variety of factors including the rating requirements of the NRSROs, investor preferences or demands, accounting and regulatory capital considerations, and whether there was a market for the type of interest that might ordinarily be retained (at least initially by the sponsor).

The agencies requested comment on the appropriateness of the menu of options in the original proposal and the permissible forms of risk retention that were proposed. Commenters generally

<sup>38</sup> See 15 U.S.C. 78o–11(c)(1)(C)(i); see also S. Rep. No. 111–176, at 130 (2010) (“The Committee [on Banking, Housing, and Urban Affairs] believes that implementation of risk retention obligations should recognize the differences in securitization practices for various asset classes.”).

<sup>39</sup> See Board Report; see also *Macroeconomic Effects of Risk Retention Requirements*, Chairman of the Financial Stability Oversight Counsel (January 2011), available at [http://www.treasury.gov/initiatives/wsr/Documents/Section 946 Risk Retention Study \(FINAL\).pdf](http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20(FINAL).pdf).

supported the menu-based approach of providing sponsors with the flexibility to choose from a number of permissible forms of risk retention. Many commenters requested that sponsors be permitted to use multiple risk retention options in any percentage combination, as long as the aggregate percentage of risk retention would be at least 5 percent.

The agencies continue to believe that providing options for risk retention is appropriate in order to accommodate the variety of securitization structures that would be subject to the proposed rule. Accordingly, subpart B of the proposed rule would maintain a menu of options approach to risk retention. Additionally, the agencies have considered commenters' concerns about flexibility in combining forms of risk retention and are proposing modifications to the various forms of risk retention, and how they may be used, to increase flexibility and facilitate different circumstances that may accompany various securitization transactions. Additionally, the permitted forms of risk retention in the proposal would be subject to terms and conditions that are intended to help ensure that the sponsor (or other eligible entity) retains an economic exposure equivalent to at least 5 percent of the credit risk of the securitized assets. Each of the forms of risk retention being proposed by the agencies is described below.

#### 1. Standard Risk Retention

##### a. Overview of Original Proposal and Public Comments

In the original proposal, to fulfill risk retention for any transactions (standard risk retention), the agencies proposed to allow sponsors to use one of three methods: (i) Vertical risk retention; (ii) horizontal risk retention; and (iii) L-shaped risk retention.

Under the vertical risk retention option in the original proposal, a sponsor could satisfy its risk retention requirement by retaining at least 5 percent of each class of ABS interests issued as part of the securitization transaction. As discussed in the original proposal, this would provide the sponsor with an interest in the entire securitization transaction. The agencies received numerous comments supporting the vertical risk retention option as an appropriate way to align the interests of the sponsor with those of the investors in the ABS in a manner that would be easy to calculate. However, some commenters expressed concern that the vertical risk retention option would expose the sponsor to

substantially less risk of loss than if the sponsor had retained risk under the horizontal risk retention option, thereby making risk retention less effective.

Under the horizontal risk retention option in the original proposal, a sponsor could satisfy its risk retention obligations by retaining a first-loss “eligible horizontal residual interest” in the issuing entity in an amount equal to at least 5 percent of the par value of all ABS interests in the issuing entity that were issued as part of the securitization transaction. In lieu of holding an eligible horizontal residual interest, the original proposal allowed a sponsor to cause to be established and funded, in cash, a reserve account at closing (horizontal cash reserve account) in an amount equal to at least 5 percent of the par value of all the ABS interests issued as part of the transaction (*i.e.*, the same dollar amount (or corresponding amount in the foreign currency in which the ABS are issued, as applicable) as would be required if the sponsor held an eligible horizontal residual interest).

Under the original proposal, an interest qualified as an eligible horizontal residual interest only if it was an ABS interest that was allocated all losses on the securitized assets until the par value of the class was reduced to zero and had the most subordinated claim to payments of both principal and interest by the issuing entity. While the original proposal would have permitted the eligible horizontal residual interest to receive its pro rata share of scheduled principal payments on the underlying assets in accordance with the relevant transaction documents, the eligible horizontal residual interest generally could not receive any other payments of principal made on a securitized asset (including prepayments) until all other ABS interests in the issuing entity were paid in full.

The agencies solicited comment on the structure of the eligible horizontal residual interest, including the proposed approach to measuring the size of the eligible horizontal residual interest and the proposal to restrict unscheduled payments of principal to the sponsor holding horizontal risk retention. Several commenters expressed support for the horizontal risk retention option and believed that it would effectively align the interests of the sponsor with those of the investors in the ABS. However, many commenters raised concerns about the agencies’ proposed requirements for the eligible horizontal residual interest. Many commenters requested clarification as to the definition of “par value” and how sponsors should calculate the eligible horizontal residual interest when

measuring it against 5 percent of the par value of the ABS interests. Moreover, several commenters recommended that the agencies use different approaches to the measurement of the eligible horizontal residual interest. A few of these commenters recommended the agencies take into account the “fair value” of the ABS interests as a more appropriate economic measure of risk retention.

Several commenters pointed out that the restrictions in the original proposal on principal payments to the eligible horizontal residual interest would be impractical to implement. For example, some commenters expressed concern that the restriction would prevent the normal operation of a variety of ABS structures, where servicers do not distinguish which part of a monthly payment is interest or principal and which parts of principal payments are scheduled or unscheduled.

The original proposal also contained an “L-shaped” risk retention option, whereby a sponsor, subject to certain conditions, could use an equal combination of vertical risk retention and horizontal risk retention to meet its 5 percent risk retention requirement.<sup>40</sup>

The agencies requested comment on whether a higher proportion of the risk retention held by a sponsor under this option should be composed of a vertical component or a horizontal component. Many commenters expressed general support for the L-shaped option, but recommended that the agencies allow sponsors to utilize multiple risk retention options in different combinations or in any percentage combination as long as the aggregate percentage of risk retained is at least 5 percent. Commenters suggested that the flexibility would permit sponsors to fulfill the risk retention requirements by selecting a method that would minimize the costs of risk retention to sponsors and any resulting increase in costs to borrowers.

#### b. Proposed Combined Risk Retention Option

The agencies carefully considered all of the comments on the horizontal,

<sup>40</sup> Specifically, the original proposal would have allowed a sponsor to meet its risk retention obligations under the rules by retaining: (1) Not less than 2.5 percent of each class of ABS interests in the issuing entity issued as part of the securitization transaction (the vertical component); and (2) an eligible horizontal residual interest in the issuing entity in an amount equal to at least 2.564 percent of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction, other than those interests required to be retained as part of the vertical component (the horizontal component).

vertical, and L-shaped risk retention with respect to the original proposal.

In the proposed rule, to provide more flexibility to accommodate various sponsors and securitization transactions and in response to comments, the agencies are proposing to combine the horizontal, vertical, and L-shaped risk retention options into a single risk retention option with a flexible structure.<sup>41</sup> Additionally, to provide greater clarity for the measurement of risk retention and to help prevent sponsors from structuring around their risk retention requirement by negating or reducing the economic exposure they are required to maintain, the proposal would require sponsors to measure their risk retention requirement using fair value, determined in accordance with U.S. generally accepted accounting principles (GAAP).<sup>42</sup>

The proposed rule would provide for a combined standard risk retention option that would permit a sponsor to satisfy its risk retention obligation by retaining an “eligible vertical interest,” an “eligible horizontal residual interest,” or any combination thereof, in a total amount equal to no less than 5 percent of the fair value of all ABS interests in the issuing entity that are issued as part of the securitization transaction. The eligible horizontal residual interest may consist of either a single class or multiple classes in the issuing entity, provided that each interest qualifies, individually or in the aggregate, as an eligible horizontal residual interest.<sup>43</sup> In the case of multiple classes, this requirement would mean that the classes must be in consecutive order based on subordination level. For example, if there were three levels of subordinated classes and the two most subordinated classes had a combined fair value equal to 5 percent of all ABS interests, the sponsor would be required to retain these two most subordinated classes if it were going to discharge its risk retention obligations by holding only eligible horizontal residual interests. As discussed below, the agencies are proposing to refine the definitions of the eligible vertical interest and the eligible horizontal residual interest as well.

This standard risk retention option would provide sponsors with greater flexibility in choosing how to structure their retention of credit risk in a manner compatible with the practices of the securitization markets. For example, in

<sup>41</sup> See proposed rule at § \_\_.4.

<sup>42</sup> Cf. Financial Accounting Standards Board Accounting Standards Codification Topic 820.

<sup>43</sup> See proposed rule at § \_\_.2 (definition of “eligible horizontal residual interest”).

securitization transactions where the sponsor would typically retain less than 5 percent of an eligible horizontal residual interest, the standard risk retention option would permit the sponsor to hold the balance of the risk retention as a vertical interest. In addition, the flexible standard risk retention option should not in and of itself result in a sponsor having to consolidate the assets and liabilities of a securitization vehicle onto its own balance sheet because the standard risk retention option does not mandate a particular proportion of horizontal to vertical interest or require retention of a minimum eligible horizontal residual interest. Under the proposed rule, a sponsor would be free to hold more of an eligible vertical interest in lieu of an eligible horizontal residual interest. The inclusion of more of a vertical interest could reduce the significance of the risk profile of the sponsor's economic exposure to the securitization vehicle. The significance of the sponsor's exposure is one of the characteristics the sponsor evaluates when determining whether to consolidate the securitization vehicle for accounting purposes.

As proposed, a sponsor may satisfy its risk retention requirements with respect to a securitization transaction by retaining at least 5 percent of the fair value of each class of ABS interests issued as part of the securitization transaction. A sponsor using this approach must retain at least 5 percent of the fair value of each class of ABS interests issued in the securitization transaction regardless of the nature of the class of ABS interests (*e.g.*, senior or subordinated) and regardless of whether the class of interests has a par value, was issued in certificated form, or was sold to unaffiliated investors. For example, if four classes of ABS interests were issued by an issuing entity as part of a securitization—a senior AAA-rated class, a subordinated class, an interest-only class, and a residual interest—a sponsor using this approach with respect to the transaction would have to retain at least 5 percent of the fair value of each such class or interest.

A sponsor may also satisfy its risk retention requirements under the vertical option by retaining a "single vertical security." A single vertical security would be an ABS interest entitling the holder to a specified percentage (*e.g.*, 5 percent) of the principal and interest paid on each class of ABS interests in the issuing entity (other than such single vertical security) that result in the security representing the same percentage of fair value of each class of ABS interests. By permitting the

sponsor to hold the vertical form of risk retention as a single security, the agencies intend to provide sponsors an option that is simpler than carrying multiple securities representing a percentage share of every series, tranche, and class issued by the issuing entity, each of which might need to be valued by the sponsor on its financial statements every financial reporting period. The single vertical security option provides the sponsor with the same principal and interest payments (and losses) as the vertical stack, in the form of one security to be held on the sponsor's books.

The agencies considered the comments on the measurement of the eligible horizontal residual interest in the original proposal and are proposing a fair value framework for calculating the standard risk retention because it uses methods more consistent with market practices. The agencies' use of par value in the original proposal sought to establish a simple and transparent measure, but the PCCRA requirement, which the agencies proposed to ensure that the eligible horizontal residual interest had true economic value, tended to introduce other complexities. In addition, the use of fair value as defined in GAAP provides a consistent framework for calculating standard risk retention across very different securitization transactions and different classes of interests within the same type of securitization structure.

However, fair value is a methodology susceptible to yielding a range of results depending on the key variables selected by the sponsor in determining fair value. Accordingly, as part of the agencies' proposal to rely on fair value as a measure that will adequately reflect the amount of a sponsor's economic "skin in the game," the agencies propose to require disclosure of the sponsor's fair value methodology and all significant inputs used to measure its eligible horizontal residual interest, as discussed below in this section. Sponsors that elect to utilize the horizontal risk retention option must disclose the reference data set or other historical information which would meaningfully inform third parties of the reasonableness of the key cash flow assumptions underlying the measure of fair value. For the purposes of this requirement, key assumptions may include default, prepayment, and recovery. The agencies believe these key metrics will help investors assess whether the fair value measure used by the sponsor to determine the amount of its risk retention are comparable to market expectations.

The agencies are also proposing limits on payments to holders of the eligible horizontal residual interest, but the limits differ from those in the original proposal, based on the fair value measurement. The agencies continue to believe that limits are necessary to establish economically meaningful horizontal risk retention that better aligns the sponsor's incentives with those of investors. However, the agencies also intend for sponsors to be able to satisfy their risk retention requirements with the retention of an eligible horizontal residual interest in a variety of ABS structures, including those structures that, in contrast to mortgage-backed securities transactions, do not distinguish between principal and interest payments and between principal losses and other losses.

The proposed restriction on projected cash flows to be paid to the eligible horizontal residual interest would limit how quickly the sponsor can recover the fair value amount of the eligible horizontal residual interest in the form of cash payments from the securitization (or, if a horizontal cash reserve account is established, released to the sponsor or other holder of such account). The proposed rule would prohibit the sponsor from structuring a deal where it receives such amounts at a faster rate than the rate at which principal is paid to investors in all ABS interests in the securitization, measured for each future payment date. Since the cash flows projected to be paid to sponsors (or released to the sponsor or other holder of the horizontal cash reserve account) and all ABS interests would already be calculated at the closing of the transactions as part of the fair value calculation, it should not be unduly complex or burdensome for sponsors to project the cash flows to be paid to the eligible horizontal residual interest (or released to the sponsor or other holder of the horizontal cash reserve account) and the principal to be paid to all ABS interests on each payment date. To compute the fair value of projected cash flows to be paid to the eligible horizontal residual interest (or released to the sponsor or other holder of the horizontal cash reserve account) on each payment date, the sponsor would discount the projected cash flows to the eligible horizontal residual interest on each payment date (or released to the sponsor or other holder of the horizontal cash reserve account) using the same discount rate that was used in the fair value calculation (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). To compute the cumulative fair value of cash flows projected to be paid to the eligible horizontal residual interest through each payment date, the sponsor would add the fair value of cash flows to the eligible horizontal residual interest (or released to the sponsor or other holder of the horizontal cash reserve account) from issuance through each payment date (or the termination of the horizontal cash reserve account). The ratio of the cumulative fair value of cash flows projected to be paid to the eligible horizontal residual interest (or released to the sponsor or other holder of the horizontal cash reserve account) at each payment date divided by the fair value of the eligible horizontal residual interest (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) at issuance (the EHRI recovery percentage) measures how quickly the sponsor can be projected to recover the fair value of the eligible horizontal residual interest. To measure how quickly investors as a whole are projected to be repaid principal through each payment date, the sponsor would divide the cumulative amount of principal projected to be paid to all ABS interests through each payment date by the total principal of ABS interests at issuance (ABS recovery percentage).

In order to comply with the proposed rule, the sponsor, prior to the issuance of the eligible horizontal residual interest (or funding a horizontal cash reserve account), or at the time of any subsequent issuance of ABS interests, as applicable, would have to certify to investors that it has performed the calculations required by section 4(b)(2)(i) of the proposed rule and that the EHRI recovery percentages are not expected to be larger than the ABS recovery percentages for any future payment date.<sup>44</sup> In addition, the sponsor would have to maintain record of such calculations and certifications in written form in its records and must provide disclosure upon request to the Commission and its appropriate Federal banking agency, if any, until three years after all ABS interests are no longer outstanding. If this test fails for any payment date, meaning that the eligible horizontal residual interest is projected to recover a greater percentage of its fair value than the percentage of principal projected to be repaid to all ABS interests with respect to such future payment date, the sponsor, absent provisions in the cash flow waterfall that prohibit such excess projected payments from being made on such

payment date, would not be in compliance with the requirements of section 4(b)(2) of the proposed rule. For example, the schedule of target overcollateralization in an automobile loan securitization might need to be adjusted so that the sponsor's retained interest satisfies the eligible horizontal residual interest repayment restriction.

The cash flow projection would be a one-time calculation performed at issuance on projected cash flows. This is in part to limit operational burdens and to allow for sponsors to receive the upside from a transaction performing above expectations in a timely fashion. It should also minimize increases in the cost of credit to borrowers as a result of the risk retention requirement. At the same time, the restriction that a sponsor cannot structure a transaction in which the sponsor is projected to recover the fair value of the eligible horizontal residual interest any faster than all investors are repaid principal should help to maintain the alignment of interests of the sponsor with those of investors in the ABS, while providing flexibility for various types of securitization structures. Moreover, the restriction would permit a transaction to be structured so that the sponsor could receive a large, one-time payment, which is a feature common in deals where certain cash flows that would otherwise be paid to the eligible horizontal residual interest are directed to pay other classes, such as a money market tranche in an automobile loan securitization, provided that such payment did not cause a failure to satisfy the projected payment test.

On the other hand, the restriction would prevent the sponsor from structuring a transaction in which the sponsor is projected to be paid an amount large enough to increase the leverage of the transaction by more than the amount which existed at the issuance of the asset-backed securities. In other words, the purpose of the restriction is to prevent sponsors from structuring a transaction in which the eligible horizontal residual interest is projected to receive such a disproportionate amount of money that the sponsor's interests are no longer aligned with investors' interests. For example, if the sponsor has recovered all of the fair value of an eligible horizontal residual interest, the sponsor effectively has no retained risk if losses on the securitized assets occur later in the life of the transaction.

In addition, in light of the fact that the EHRI recovery percentage calculation is determined one time, before closing of the transaction, based on the sponsor's projections, the agencies are proposing

to include an additional disclosure requirement about the sponsor's past performance in respect to the EHRI recovery percentage calculation. For each transaction that includes an EHRI, the sponsor will be required to make a disclosure that looks back to all other EHRI transactions the sponsor has brought out under the requirements of the risk retention rules for the previous five years, and disclose the number of times the actual payments made to the sponsor under the EHRI exceeded the amounts projected to be paid to the sponsor in determining the Closing Date Projected Cash Flow Rate (as defined in section 4(a) of the proposed rule).

Similar to the original proposal, the proposed rule would allow a sponsor, in lieu of holding all or part of its risk retention in the form of an eligible horizontal residual interest, to cause to be established and funded, in cash, a reserve account at closing (horizontal cash reserve account) in an amount equal to the same dollar amount (or corresponding amount in the foreign currency in which the ABS are issued, as applicable) as would be required if the sponsor held an eligible horizontal residual interest.<sup>45</sup>

This horizontal cash reserve account would have to be held by the trustee (or person performing functions similar to a trustee) for the benefit of the issuing entity. Some commenters on the original proposal recommended relaxing the investment restrictions on the horizontal cash reserve account to accommodate foreign transactions. The proposed rule includes several important restrictions and limitations on such a horizontal cash reserve account to ensure that a sponsor that establishes a horizontal cash reserve account would be exposed to the same amount and type of credit risk on the underlying assets as would be the case if the sponsor held an eligible horizontal residual interest. For securitization transactions where the underlying loans or the ABS interests issued are denominated in a foreign currency, the amounts in the account may be invested in sovereign bonds issued in that foreign currency or in fully insured deposit accounts denominated in the foreign currency in a foreign bank (or a subsidiary thereof) whose home country supervisor (as defined in section 211.21 of the Board's Regulation K)<sup>46</sup> has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision, as amended, provided the foreign bank is

<sup>44</sup> See proposed rule at § \_\_.4(b).

<sup>45</sup> See proposed rule at § \_\_.4(c).

<sup>46</sup> 12 CFR 211.21.

subject to such standards.<sup>47</sup> In addition, amounts that could be withdrawn from the account to be distributed to a holder of the account would be restricted to the same degree as payments to the holder of an eligible horizontal residual interest (such amounts to be determined as though the account was an eligible horizontal residual interest), and the sponsor would be required to comply with all calculation requirements that it would have to perform with respect to an eligible horizontal residual interest in order to determine permissible distributions from the cash account.

Disclosure requirements would also be required with respect to a horizontal cash reserve account, including the fair value and calculation disclosures required with respect to an eligible horizontal residual interest, as discussed below.

The original proposal included tailored disclosure requirements for the vertical, horizontal, and L-shaped risk retention options. A few commenters recommended deleting the proposed requirement that the sponsor disclose the material assumptions and methodology used in determining the aggregate dollar amount of ABS interests issued by the issuing entity in the securitization. In the proposed rule, the agencies are proposing disclosure requirements similar to those in the original proposal, with some modifications, and are proposing to add new requirements for the fair value measurement and to reflect the structure of the proposed standard risk retention option.

The proposed rule would require sponsors to provide or cause to be provided to potential investors a reasonable time prior to the sale of ABS interests in the issuing entity and, upon request, to the Commission and its appropriate Federal banking agency (if any) disclosure of:

- The fair value (expressed as a percentage of the fair value of all 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)) of the eligible horizontal residual interest that will be retained (or was retained) by the sponsor at closing, and the fair value (expressed as a percentage of the fair value of all 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)) of the eligible horizontal residual interest required to be retained by the sponsor in connection with the securitization transaction;

- A description of the material terms of the eligible horizontal residual interest to be retained by the sponsor;
- 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 the range of information considered in arriving at such key inputs and assumptions and an indication of the weight ascribed thereto) and the sponsor's technique(s) to derive the key inputs;

- For sponsors that elect to utilize the horizontal risk retention option, the reference data set or other historical information that would enable investors and other stakeholders to assess the reasonableness of the key cash flow assumptions underlying the fair value of the eligible horizontal residual interest. Examples of key cash flow assumptions may include default, prepayment, and recovery;
- Whether any retained vertical interest is retained as a single vertical security or as separate proportional interests;
- 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; and
- The fair value (expressed as a percentage of the fair value of all 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)) of any single vertical security or separate proportional interests that will be retained (or was retained) by the sponsor at closing, and the fair value (expressed as a percentage of the fair value of all 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)) of the single vertical security or separate proportional interests required to be

retained by the sponsor in connection with the securitization transaction.

Consistent with the original proposal, a sponsor electing to establish and fund a horizontal cash reserve account would be required to provide disclosures similar to those required with respect to an eligible horizontal residual interest, except that these disclosures have been modified to reflect the different nature of the account.

#### Request for Comment

1(a). Should the agencies require a minimum proportion of risk retention held by a sponsor under the standard risk retention option to be composed of a vertical component or a horizontal component? 1(b). Why or why not?

2(a). The agencies observe that horizontal risk retention, as first-loss residual position, generally would impose the most economic risk on a sponsor. Should a sponsor be required to hold a higher percentage of risk retention if the sponsor retains only an eligible vertical interest under this option or very little horizontal risk retention? 2(b). Why or why not?

3. Are the disclosures proposed sufficient to provide investors with all material information concerning the sponsor's retained interest in a securitization transaction and the methodology used to calculate fair value, as well as enable investors and the agencies to monitor whether the sponsor has complied with the rule?

4(a). Is the requirement for sponsors that elect to utilize the horizontal risk retention option to disclose the reference data set or other historical information that would enable investors and other stakeholders to assess the reasonableness of the key cash flow assumptions underlying the fair value of the eligible horizontal residual interest useful? 4(b). Would the requirement to disclose this information impose a significant cost or undue burden to sponsors? 4(c). Why or why not? 4(d). If not, how should proposed disclosures be modified to better achieve those objectives?

5(a). Does the proposal require disclosure of any information that should not be made publicly available? 5(b). If so, should such information be made available to the Commission and Federal banking agencies upon request?

6. Are there any additional factors that the agencies should consider with respect to the standard risk retention?

7. To what extent would the flexible standard risk retention option address concerns about a sponsor having to consolidate a securitization vehicle for accounting purposes due to the risk retention requirement itself, given that

<sup>47</sup> Otherwise, as in the original proposal, amounts in a horizontal cash reserve account may only be invested in: (1) United States Treasury securities with remaining maturities of one year or less; and (2) 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. See proposed rule at § .4(c)(2).

the standard risk retention option does not require a particular proportion of horizontal to vertical interest?

8(a). Is the proposed approach to measuring risk retention appropriate?

8(b). Why or why not?

9(a). Would a different measurement of risk retention be more appropriate? 9(b). Please provide details and data supporting any alternative measurement methodologies.

10(a). Is the restriction on certain projected payments to the sponsor with respect to the eligible horizontal residual interest appropriate and sufficient? 10(b). Why or why not?

11(a). The proposed restriction on certain projected payments to the sponsor with respect to the eligible horizontal residual interest compares the rate at which the sponsor is projected to recover the fair value of the eligible horizontal residual interest with the rate which all other investors are projected to be repaid their principal. Is this comparison of two different cash flows an appropriate means of providing incentives for sound underwriting of ABS? 11(b). Could it increase the cost to the sponsor of retaining an eligible horizontal residual interest? 11(c). Could sponsors or issuers manipulate this comparison to reduce the cost to the sponsor of retaining an eligible horizontal residual interest? How? 11(d). If so, are there adjustments that could be made to this requirement that would reduce or eliminate such possible manipulation? 11(e). Would some other cash flow comparison be more appropriate? 11(f). If so, which cash flows should be compared? 11(g). Does the proposed requirement for the sponsor to disclose, for previous ABS transactions, the number of times the sponsor was paid more than the issuer predicted for such transactions reach the right balance of incremental burden to the sponsor while providing meaningful information to investors? 11(h). If not, how should it be modified to better achieve those objectives?

12(a). Does the proposed form of the single vertical security accomplish the agencies' objective of providing a way for sponsors to hold vertical risk retention without the need to perform valuation of multiple securities for accounting purposes each financial reporting period? 12(b). Is there a different approach that would be more efficient?

13(a). Is three years after all ABS interests are no longer outstanding an appropriate time period for the sponsors' record maintenance requirement with respect to the calculations and other requirements in section 4? 13(b). Why or why not? 13(c).

If not, what would be a more appropriate time period?

14(a). Would the calculation requirements in section 4 of the proposed rule likely be included in agreed upon procedures with respect to an interest retained pursuant to the proposed rule? 14(b). Why or why not? 14(c). If so, what costs may be associated with such a practice?

#### c. Alternative Eligible Horizontal Residual Interest Proposal

The agencies have also considered, and request comment on, an alternative provision relating to the amount of principal payments received by the eligible horizontal residual interest. Under this alternative, on any payment date, in accordance with the transaction's governing documents, the cumulative amount paid to an eligible horizontal residual interest may not exceed a proportionate share of the cumulative amount paid to all holders of ABS interests in the transaction. The proportionate share would equal the percentage, as measured on the date of issuance, of the fair value of all of the ABS interests issued in the transaction that is represented by the fair value of the eligible horizontal residual interest.

For purposes of this calculation, fees and expenses paid to service providers would not be included in the cumulative amounts paid to holders of ABS interests. All other amounts paid to holders of ABS would be included in the calculations, including principal repayment, interest payments, excess spread and residual payments. The transaction documents would not allow distribution to the eligible horizontal residual interest any amounts payable to the eligible horizontal residual interest that would exceed the eligible horizontal residual interest's permitted proportionate share. Such excess amounts could be paid to more senior classes, placed into a reserve account, or allocated in any manner that does not otherwise result in payments to the holder of the eligible horizontal residual interest that would exceed the allowed amount.

By way of illustration, assume the fair value of the eligible horizontal residual interest for a particular transaction was equal to 10 percent of the fair value of all ABS interests issued in that transaction. In order to meet the requirements of the proposal, the cumulative amount paid to the sponsor in its capacity as holder of the eligible horizontal residual interest on any given payment date could not exceed 10 percent of the cumulative amount paid to all holders of ABS interests, excluding payment of expenses and fees

to service providers. This would allow large payments to the eligible horizontal residual interest so long as such payments do not otherwise result in payments to the holder of the eligible horizontal residual interest that would exceed the allowed amount.

The agencies request comment on this alternative mechanism for allowing the eligible horizontal residual interest to receive unscheduled principal payments, including whether the agencies should adopt the alternative proposal instead of the proposed mechanism for these payments described above.

#### Request for Comment

15(a). Other than a cap in the priority of payments on amounts to be paid to the eligible horizontal residual interest and related calculations on distribution dates and related provisions to allocate any amounts above the cap, would there be any additional steps necessary to comply with the alternative proposal? 15(b). If so, please describe those additional steps and any associated costs.

16. Would the cost and difficulty of compliance with the alternative proposal, including monitoring compliance, be higher or lower, than with the proposal?

17(a). Does the alternative proposal accommodate more or less of the current market practice than the proposal? 17(b). If there is a difference, please provide data with respect to the scale of that difference.

18. With respect to the alternative proposal, should amounts other than payment of expenses and fees to service providers be excluded from the calculations?

19(a). Does the alternative proposal adequately accommodate structures with unscheduled payments of principal, such as scheduled step downs? 19(b). Does the alternative adequately address structures which do not distinguish between interest and principal received from underlying assets for purposes of distributions?

20(a). Are there asset classes or transaction structures for which the alternative proposal would not be economically viable? 20(b). Are there asset classes or transaction structures for which the alternative proposal would be more economically feasible than the proposal?

21. Should both the proposal and the alternative proposal be made available to sponsors?

22(a). The proposal includes a restriction on how payments on an eligible horizontal residual interest must be structured but does not restrict actual

payments to the eligible horizontal residual interest, which could be different than the projected payments if losses are higher or lower than expected. The alternative proposal for payments on eligible horizontal residual interests does not place restrictions on structure but does restrict actual payments to the eligible horizontal residual interest. Does the proposal or the alternative proposal better align the sponsor's interests with investors' interests? 22(b). Why or why not?

## 2. Revolving Master Trusts

### a. Overview

Securitization sponsors frequently use a revolving master trust when they seek to issue more than one series of ABS collectively backed by a common pool of assets that change over time.<sup>48</sup> Pursuant to the original proposal, the seller's interest form of risk retention would only be available to revolving master trusts.

The seller's interest is an undivided interest held by the master trust securitization sponsor in the pool of receivables or loans held in the trust. It entitles the sponsor to a percentage of all payments of principal, interest, and fees, as well as recoveries from defaulted assets that the trust periodically receives on receivables and loans held in the trust, as well as the same percentage of all payment defaults on those assets. Investors in the various series of ABS issued by the trust have claims on the remaining principal and interest, as a source of repayment for the ABS interests they hold.<sup>49</sup> Typically, the seller's interest is *pari passu* to the investors' interest with respect to collections and losses on the securitized assets, though in some revolving master trusts, it is subordinated to the investors' interest in this regard. If the seller's interest is *pari passu*, it generally becomes subordinated to

<sup>48</sup> In a revolving master trust securitization, assets (e.g., credit card receivables or dealer floorplan financings) are periodically added to the pool to collateralize current and future issuances of the securities backed by the pool. Often, but not always, the assets are receivables generated by revolving lines of credit originated by the sponsor. A major exception would be the master trusts used in the United Kingdom to finance residential mortgages.

<sup>49</sup> Generally, the trust sponsor retains the right to any excess cash flow from payments of interest and fees received by the trust that exceeds the amount owed to ABS investors. Excess cash flow from payments of principal is paid to the sponsor in exchange for newly generated receivables in the trust's existing revolving accounts. However, the specific treatment of excess interest, fees, and principal payments with respect to any ABS series within the trust is a separate issue, discussed in connection with the agencies' proposal to give sponsors credit for some forms of eligible horizontal risk retention at the series level, as explained in further detail below.

investors' interests in the event of an early amortization of the ABS interests held by investors, as discussed more below. Commenters representing the interests of securitization sponsors generally favored the seller's interest approach but requested certain modifications.

The agencies are proposing to maintain the seller's interest as the specific risk retention option for master trusts, with changes from the original proposal that reflect many of the comments received, as discussed in further detail below. The modifications to this option are intended to refine this method of risk retention to better reflect the way revolving master trust securitizations operate in the current market.

As discussed in greater detail below, among other things, the agencies are proposing to modify the original proposal with respect to master trusts by:

- Allowing sponsors that hold a first-loss exposure in every series of ABS issued by a master trust to count the percent of such interest that is held consistently across all ABS series toward the minimum 5 percent seller's interest requirement;
- Removing the restriction in the original proposal that prohibited the use of the seller's interest risk retention option for master trust securitizations backed by non-revolving assets;
- Clarifying how the seller's interest can be used in connection with multi-level legacy trusts and master trusts in which some of the seller's interest corresponds to loans or receivables held in a legacy master trust;
- Revising the calculation of the 5 percent seller's interest amount so it is based on the trust's amount of outstanding ABS rather than the amount of trust assets;
- Clarifying the rules regarding the use of certain structural features, including delinked credit enhancement structures, where series-specific credit enhancements that do not support the seller's interest-linked structures, and the limited use of assets that are not part of the seller's interest to administer the features of the ABS issued to investors; and
- Clarify how the rule would apply to a revolving master trust in early amortization.

### b. Definitions of Revolving Master Trust and Seller's Interest

The seller's interest form of retention would only be available to revolving master trusts. These are trusts established to issue ABS interests on multiple issuance dates out of the same

trust. In some instances the trust will issue to investors a series with multiple classes of tranching ABS periodically. In others, referred to as "delinked credit enhancement structures," the master trust maintains one or more series, but issues tranches of ABS of classes in the series periodically, doing so in amounts that maintain levels of subordination between classes as required in the transaction documents. The revolving master trust risk retention option is designed to accommodate both of these structures.

The agencies' original proposal would require that all securitized assets in the master trust must be loans or other extensions of credit that arise under revolving accounts. The agencies received comments indicating that a small number of securitizers in the United States, such as insurance premium funding trusts, use revolving trusts to securitize short-term loans, replacing loans as they mature with new loans, in order to sustain cash flow and collateral support to longer-term securities. In response to commenters, the agencies are proposing to expand the securitized asset requirement to include non-revolving loans.<sup>50</sup> Nevertheless, as with the original proposal, all ABS interests issued by the master trust must be collateralized by the master trust's common pool of receivables or loans. Furthermore, the common pool's principal balance must revolve so that cash representing principal remaining after payment of principal due, if any, to outstanding ABS on any payment date, as well as cash flow from principal payments allocated to seller's interest is reinvested in new extensions of credit at a price that is predetermined at the transaction and new receivables or loans are added to the pool from time to time to collateralize existing series of ABS issued by the trust. The seller's interest option would not be available to a trust that issues series of ABS at different times backed by segregated independent pools of securitized assets within the trust as a series trust, or a trust that issues shorter-term ABS interests backed by a static pool of long-term loans, or a trust with a re-investment period that precedes an ultimate amortization period.

In general, the seller's interest represents the seller/sponsor's interest in the portion of the receivables or loans that does not collateralize outstanding

<sup>50</sup> Revolving master trusts are also used in the United Kingdom to securitize mortgages, and U.S. investors may invest in RMBS issued by these trusts. This proposed change would make it easier for these issuers to structure their securitizations in compliance with section 15C for such purpose.

investors' interests in ABS issued under series. Investor interests include any sponsor/seller's retained ABS issued under a series. As discussed above, a seller's interest is a typical form of risk retention in master trusts, whereby the sponsor of a master trust holds an undivided interest in the securitized assets. The original proposal defined "seller's interest" consistent with these features, as an ABS interest (i) in all of the assets that are held by the issuing entity and that do not collateralize any other ABS interests issued by the entity; (ii) that is *pari passu* with all other ABS interests issued by the issuing entity with respect to the allocation of all payments and losses prior to an early amortization event (as defined in the transaction documents); and (iii) that adjusts for fluctuations in the outstanding principal balances of the securitized assets.

The proposal would define "seller's interest" similarly to the original proposal. However, in response to comments, the agencies have made changes to the definition from the original proposal to reflect market practice. The first change would modify the definition to reflect the fact that the seller's interest is *pari passu* with investors' interests at the series level, not at the level of all investors' interests collectively. The agencies are proposing this change because each series in a revolving master trust typically uses senior-subordinate structures under which investors are entitled to different payments out of that series' percentage share of the collections on the trust's asset pool, so some investors in subordinated classes are subordinate to the seller's interest. The second change would modify the definition to reflect the fact that, in addition to the receivables and loans that collateralize the trust's ABS interests, a master trust typically includes servicing assets.<sup>51</sup> To the extent these assets are allocated as collateral only for a specific series, these assets are not part of the seller's interest.<sup>52</sup> Furthermore, the proposal

clarifies that the seller's interest amount is the unpaid principal balance of the seller's interest in the common pool of receivables or loans. The seller's interest amount must at least equal the required minimum seller's interest.

In addition, the agencies are considering whether they should make additional provisions for subordinated seller's interests. In some revolving master trusts, there is an interest similar to a seller's interest, except that instead of the interest being *pari passu* with the investors' interest with respect to principal collections and interest and fee collections, the sponsor's (or depositor's) share of the collections in the interest are subordinated, to enhance the ABS interests issued to investors at the series level. The agencies are considering whether to permit these subordinated interests to count towards the 5 percent seller's interest treatment, since they perform a loss-absorbing function that is analogous to a horizontal interest (whereas a typical seller's interest is analogous to a vertical interest, and typically is only subordinated in the event of early amortization). Because they are subordinated, however, the agencies are considering requiring them be counted toward the 5 percent requirement on a fair value basis, instead of the face value basis applied for regular, unsubordinated seller's interests.<sup>53</sup> The sponsor would be required to apply the same fair value standards as the rule imposes under the general risk retention requirement.

In addition to these definitional changes, the agencies are proposing modifications to the overall structure of the master trust risk retention option as it was proposed in the original proposal, in light of comments concerning the manner in which the seller's interest is held. In some cases, the seller's interest may be held by the sponsor, as was specified in the original proposal, but in other instances, it may be held by another entity, such as the depositor, or two or more originators may sponsor a single master trust to securitize receivables generated by both firms, with each firm holding a portion of the seller's interest. Accordingly, the agencies are proposing to allow the

revolving versus amortizing periods for investor ABS series, implementation of interest rate features, and similar aspects of these securitization transactions.

<sup>53</sup> The fair value determination would be for purposes of the amount of subordinated seller's interest included in the numerator of the 5 percent ratio. The denominator would be the unpaid principal balance of all outstanding investors' ABS interests, as is proposed for regular, unsubordinated seller's interests.

seller's interest to be held by any wholly-owned affiliate of the sponsor.<sup>54</sup>

In response to comments, the agencies are also proposing to allow the seller's interest to be retained in multiple interests, rather than a single interest. This approach is intended to address legacy trust structures and would impose requirements on the division of the seller's interest in such structures. In these structures, a sponsor that controls an older revolving master trust that no longer issues ABS to investors keeps the trust in place, with the credit lines that were designated to the trust over the years still in operation and generating new receivables for the legacy trust. The legacy trust issues certificates collateralized by these receivables to a newer issuing trust, which typically also has credit lines designated to the trust, providing the issuing trust with its own pool of receivables. The issuing trust issues investors' ABS interests backed by receivables held directly by the issuing trust and also indirectly in the legacy trust (as evidenced by the collateral certificates held by the issuing trust).

The proposal would permit the seller's interest for the legacy trust's receivables to be held separately, but still be considered eligible risk retention, by the sponsor at the issuing trust level because it functions as though it were part of the seller's interest associated with all the securitized assets held by the issuing trust (*i.e.*, its own receivables and the collateral certificates). However, the portion of the seller's interest held through the legacy trust must be proportional to the percentage of assets the collateral certificates comprise of the issuing trust's assets. If the sponsor held more, and the credit quality of the receivables feeding the issuing trust turned out to be inferior to the credit lines feeding the legacy trust, the sponsor would be able to avoid the full effect of those payment defaults at the issuing trust level.

The proposal would require the sponsor to retain a minimum seller's interest in the receivables or loans held by the trust representing at least 5 percent of the total unpaid principal balance of the investors' ABS interests issued by the trust and outstanding.<sup>55</sup>

<sup>54</sup> The requirement for the holder to be a wholly-owned affiliate of the sponsor is consistent with the restrictions on permissible transferees of risk retention generally required to be held by the sponsor under the rule. See Part III.D.2 of this Supplementary Information.

<sup>55</sup> The agencies originally proposed 5 percent of the total receivables and loans in the trust, but are persuaded by commenters that this is

<sup>51</sup> The definition of "servicing assets" is discussed in Part II.B of this Supplementary Information.

<sup>52</sup> Although this language allows certain assets held by the trust to be allocated as collateral only for a specific series and excluded from the seller's interest, it does not allow a trust to claim eligibility for the seller's interest form of risk retention unless the seller's interest is, consistent with the revolving master trust definition, generally collateralized by a common pool of assets, the composition of which changes over time, and that securitizes all ABS interests in the trust. Absent broad exposure to the securitized assets, the seller's interest ceases to be a vertical form of risk retention. The proposed language is designed to accommodate limited forms of exclusion from the seller's interest in connection with administering the trust, dealing with the

The sponsor would be required to meet this 5 percent test at the closing of each issuance of securities by the master trust, and at every seller's interest measurement date specified under the securitization transaction documents, but no less than monthly. The sponsor would remain subject to its obligation to meet the seller's interest requirement on these measurement dates until the trust no longer has ABS interests outstanding to any third party.

The agencies are proposing to include the principal balance instead of the fair value of outstanding ABS interests as the basis for the calculation of the minimum seller's interest requirement. The agencies currently consider this approach to be sufficiently conservative, because sponsors of revolving master trusts do not include senior interest-only bonds or premium bonds in their ABS structures. If this were not the case, it would be more appropriate to require the minimum seller's interest requirement to be included based on the fair value basis of outstanding ABS interests. However, the fair value determination would create additional complexity and costs, especially given the frequency of the measurements required. In consideration of this, the agencies would expect to include in any final rule a prohibition against the seller's interest approach for any revolving trust that includes senior interest-only bonds or premium bonds in the ABS interest it issues to investors.

#### Request for Comment

23(a). Is such prohibition appropriate? 23(b). If not, what is a better approach, and why? Commenters proposing an alternative approach should provide specific information about which revolving trusts in the marketplace currently include such interests in their capital structures, and the manner in which they could comply with a fair value approach.

24. In revising the definition of "seller's interest" the agencies have modified the rule text to exclude "assets that collateralize other specified ABS interests issued by the issuing entity" as well as rule text excluding "servicing assets," which is a defined term under the proposal. Are such exclusions redundant, or would they exclude rights to assets or cash flow that are commonly included as seller's interest?

disproportionate to the base risk retention requirement in some cases. Revolving master trusts may hold receivables far in excess of the amount of investors' ABS interests outstanding, for example, when the sponsor has other funding sources at more favorable costs than those available from investors in the master trust's ABS.

#### c. Combining Seller's Interest With Horizontal Risk Retention at the Series Level

The original proposal for revolving asset master trusts focused primarily on the seller's interest form of risk retention. Commenters requested that the agencies modify the original proposal to recognize as risk retention the various forms of subordinated exposures sponsors hold in master trust securitization transactions. The proposal would permit sponsors to combine the seller's interest with either of two horizontal types of risk retention held at the series level, one of which meets the same criteria as the standard risk retention requirement, and the other of which is eligible under the special conditions discussed below.

To be eligible to combine the seller's interest with horizontal risk retained at the series level, the sponsor would be required to maintain a specified amount of horizontal risk retention in every series issued by the trust. If the sponsor retained these horizontal interests in every series across the trust, the sponsor would be permitted to reduce its seller's interest by a corresponding percentage. For example, if the sponsor held 2 percent, on a fair value basis, of all the securities issued in each series in either of the two forms of permitted horizontal interests, the sponsor's seller's interest requirement would be reduced to 3 percent of the unpaid principal balance of all investor interests outstanding, instead of 5 percent. However, if the sponsor ever subsequently issued a series (or additional classes or tranches out of an existing series of a delinked structure) that did not meet this 2 percent minimum horizontal interest requirement, the sponsor would be required to increase its minimum seller's interest up to 5 percent for the entire trust (*i.e.*, 5 percent of the total unpaid principal balance of all the investors' ABS interest outstanding in every series, not just the series for which the sponsor decided not to hold the minimum 2 percent horizontal interest).

The agencies propose to permit the sponsor to hold horizontal interests at the series level in the form of a certificated or uncertificated ABS interest. The interest in the series would need to be issued in a form meeting the definition of an eligible horizontal residual interest or a specialized horizontal form, available only to revolving master trusts. The residual interest held by sponsors of revolving trusts at the series level typically does not meet the requirement of the proposed definition of eligible

horizontal residual interest which would limit the rate of payments to the sponsor to the rate of payments made to the holders of senior ABS interests.

Many revolving asset master trusts are collateralized with receivables that pay relatively high rates of interest, such as credit and charge card receivables or floor plan financings. The ABS interests sold to investors are structured so there is an initial revolving period, under which the series' share of borrower repayments of principal on the receivables are used by the trust to purchase new, replacement receivables. Subsequently, during the "controlled amortization" phase, principal payments are accumulated for the purpose of amortizing and paying off the securities on an expected maturity date. Under the terms of the transaction, principal payments are handled in a separate waterfall from interest payments. The series' share of interest payments received by the trust each period (typically a month) is used to pay trust expenses and the interest due to holders of ABS interests.<sup>56</sup> Because the series' share of cash flow from interest payments is generally in excess of amounts needed to pay principal and interest, it is used to cover the series' share of losses on receivables that were charged-off during the period and a surplus typically still remains. This residual interest is returned to the sponsor (though it may, under the terms of the transaction, first be made available to other series in the trust to cover shortfalls in interest due and receivable losses during the period that were not covered by other series' shares of the trust's proceeds).

This subordinated claim to residual interest by the sponsor is a form of horizontal risk retention; the residual interest is payable to the sponsor only to the extent it exceeds the amount needed to cover principal losses on more senior securities in the series. The agencies therefore believe it would be appropriate to recognize this form of risk retention as an acceptable method of meeting a sponsor's risk retention requirement for revolving master trusts. Accordingly, the agencies are proposing to recognize the fair value of the sponsor's claim to this residual interest as a permissible form of horizontal risk retention for revolving master trust structures, for which the sponsor could take credit against the seller's interest requirement in the manner described above. Under the proposal, the sponsor would receive credit for the residual interest whether it is certificated or

<sup>56</sup> In some trusts the expenses are senior in priority, but this varies.

uncertificated, subject to the following requirements:

- Each series distinguishes between the series' share of collection of interest, fees, and principal from the securitized assets (separate waterfalls);

- The sponsor's claim to any of the series' share of interest and fee proceeds each period pursuant to the horizontal residual interest is subordinated to all interest due to all ABS interests in the series for that period, and further reduced by the series' share of defaults on principal of the trust's securitized assets for that period (that is, charged-off receivables);

- The horizontal residual interest, to the extent it has claims to any part of the series' share of principal proceeds, has the most subordinated claim; and
- The horizontal residual interest is only eligible for recognition as risk retention so long as the trust is a revolving trust.

Some commenters on the original proposal also requested that the sponsor be permitted to combine the seller's interest with other vertical forms of risk retention at the series level. The agencies are not aware of any current practice of vertical holding at the series level. The agencies would consider including, as part of the seller's interest form of risk retention, vertical forms of risk retention (subject to an approach similar to the one described in this proposal for horizontal interests) if it was, in fact, market practice to hold vertical interests in every series of ABS issued by revolving master trusts. The agencies have considered this possibility but, especially in light of the lack of market practice, are not proposing to allow sponsors to meet their risk retention requirement in this manner.

In addition, the sponsor would need to make the calculations and disclosures on every measurement date required under the rule for the seller's interest and horizontal interest, as applicable, under the proposed rule. Furthermore, the sponsor would be required to retain the disclosures in its records and make them available to the Commission or supervising Federal banking agency (as applicable) until three years after all ABS interests issued in a series are no longer outstanding.

#### Request for Comment

25(a). Is there a market practice of retaining vertical forms of risk retention at the series level? 25(b). What advantages and disadvantages would there be in allowing sponsors to meet their risk retention requirement through a combination of seller's interest and vertical holdings at the series level?

26(a). Are the disclosure and recordkeeping requirements in the proposal appropriate? 26(b). Why or why not? 26(c). Is there a different time frame that would be more appropriate and if so, what would it be?

#### d. Early Amortization

The original proposal did not address the impact of early amortization on the seller's interest risk retention option. As noted above, revolving master trusts issue ABS interests with a revolving period, during which each series' share of principal collections on the trust's receivables are used to purchase replacement receivables from the sponsor. The terms of the revolving trust securitization describe various circumstances under which all series will stop revolving and principal collections will be used to amortize investors' ABS interests as quickly as possible. These terms are designed to protect investors from declines in the credit quality of the trust's asset pool. Early amortization is exceedingly rare, but when it occurs, the seller's interest may fall below its minimum maintenance level, especially if the terms of the securitization subordinate the seller's interest to investor interests either through express subordination or through a more beneficial reallocation to other investors of collections that would otherwise have been allocated to the seller's interest. Accordingly, the agencies are revising the proposed rule to address the circumstances under which a sponsor would fall out of compliance with risk retention requirements after such a reduction in the seller's interest in the early amortization context.

Under the proposed rule, a sponsor that suffers a decline in its seller's interest during an early amortization period caused by an unsecured adverse event would not violate the rule's risk retention requirements as a result of such decline, provided that each of the following four requirements were 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 investor ABS with respect to allocation of losses;
- The master trust issues no additional ABS interests after early amortization is initiated to any person not wholly-owned by the sponsor;<sup>57</sup> and

<sup>57</sup>In other words, the sponsor is not prohibited from repaying all outstanding investors' ABS interests and maintaining the trust as a legacy trust,

- To the extent that the sponsor is relying on any horizontal interests of the type described in the preceding subsection to reduce the percentage of its required seller's interest, those interests continue to absorb losses as described above.

The ability of a sponsor to avoid a violation of the risk retention in this way is only available to sponsors of master trusts comprised of revolving assets. If securitizers of ordinary non-revolving assets were permitted to avail themselves of the seller's interest and this early amortization treatment, they could create master trust transactions that revolved only briefly, with "easy" early amortization triggers, and thereby circumvent the cash distribution restrictions otherwise applicable to risk retention interests under section 4 of the proposed rule.

As an ancillary provision to this proposed early amortization treatment, the agencies are proposing to recognize so-called excess funding accounts as a supplement to the seller's interest. An excess funding account is a segregated account in the revolving master trust, to which certain collections on the securitized assets that would otherwise be payable to the holder of the seller's interest are diverted if the amount of the seller's interest falls below the minimum specified in the deal documentation.<sup>58</sup> If an early amortization event for the trust is triggered, the cash in the excess funding account is distributed to investors' ABS interests in the same manner as collections on the securitized assets. Accordingly, funding of an excess funding account would typically be temporary, eventually resolved either by the sponsor adding new securitized assets to restore the trust to its minimum seller's interest amount (and the funds trapped in the excess funding account subsequently would be paid to the sponsor), or by the subsequent early amortization of the trust for failure to attain the minimum seller's interest over multiple measurement dates.

As a general matter, the agencies would not propose to confer eligible risk retention status on an account that is funded by cash flow from securitized

which could be used at a later date to issue collateral certificates to a new issuing trust.

<sup>58</sup>Ordinarily, if the seller's interest would not meet the minimum amount required under a formula contained in the deal documentation, the sponsor is required to designate additional eligible credit plans to the transaction and transfer the receivables from those credit plans into the trust to restore the securitized assets in the trust to the specified ratio. If the sponsor cannot do this for some reason, the excess funding account activates to trap certain funds that would otherwise be paid to the sponsor out of the trust.

assets. However, for the other forms of risk retention proposed by the agencies, the amount of retention is measured and set at the inception of the transaction. Due to the revolving nature of the master trusts, periodic measurement of risk retention at the trust level is necessary for an effective seller's interest option.

The agencies are therefore proposing the above-described early amortization treatment for trusts that enter early amortization, analogous to the measurement at inception under the other approaches. If a revolving trust breaches its minimum seller's interest, the excess funding account (under the conditions described in the proposed rule) functions as an interim equivalent to the seller's interest for a brief period and gives the sponsor an opportunity to restore securitized asset levels to normal levels.<sup>59</sup> Under the proposed rule, the amount of the seller's interest may be reduced on a dollar-for-dollar basis by the amount of cash retained in an excess funding account triggered by the trust's failure to meet the minimum seller's interest, if the account is *pari passu* with (or subordinate to) each series of the investors' ABS interests and funds in the account are payable to investors in the same manner as collections on the securitized assets.

#### Request for Comment

27(a). Are there changes the agencies should consider making to the proposed early amortization and excess funding account provisions in order to align them better with market practice while still serving the agencies' stated purpose of these sections? 27(b). If so, what changes should the agencies consider?

#### e. Compliance by the Effective Date

Commenters requested that they only be required to maintain a 5 percent seller's interest for the amount of the investors' ABS interests issued after the effective date of the regulations. As a general principle, the agencies also do not seek to apply risk retention to ABS issued before the effective date of the regulations. On the other hand, the agencies believe that the treatment requested by commenters is not appropriate, because the essence of the seller's interest form of risk retention is that it is a *pro rata, pari passu* exposure to the entire asset pool. Accordingly, at

<sup>59</sup> In addition, the only excess funding account that is eligible for consideration under the proposed rule is one that is triggered from the trust's failure to meet its collateral tests in a given period; this is materially different than a violation of, for example, a base rate trigger, which signals unexpected problems with the credit quality of the securitized assets in the pool.

present, the agencies propose to require sponsors relying on the seller's interest approach to comply with the rule with respect to the entirety of the unpaid principal balance of the trust's outstanding investors' ABS interests after the effective date of the rule, without regard to whether the investors' ABS interests were issued before or after the rule's effective date.

If the terms of the agreements under which an existing master trust securitization operates do not require the sponsor to hold a minimum seller's interest to the exact terms of the proposed rule, then the sponsor could find revising the terms of outstanding series to conform to the rule's exact requirements to be difficult or impracticable. Therefore, the agencies propose to recognize a sponsor's compliance with the risk retention requirements based on the sponsor's actual conduct. If a sponsor has the ability under the terms of the master trust's documentation to retain a level of seller's interest (adjusted by qualifying horizontal interests at the series level, if any), and does not retain a level of seller's interest as required, the agencies would consider this to be failure of compliance with the proposed rule's requirements.

#### Request for Comment

28(a). The agencies request comment as to how long existing revolving master trusts would need to come into compliance with the proposed risk retention rule under the conditions described above. Do existing master trust agreements effectively prohibit compliance? 28(b). Why or why not? 28(c). From an investor standpoint, what are the implications of the treatment requested by sponsor commenters, under which sponsors would only hold a seller's interest with respect to post-effective date issuances of ABS interests out of the trust?

29(a). Should the agencies approve exceptions on a case by case basis during the post-adoption implementation period, subject to case-specific conditions appropriate to each trust? 29(b). How many trusts would need relief and under what circumstances should such relief be granted?

30. The agencies seek to formulate the seller's interest form of risk retention in a fashion that provides meaningful risk retention on par with the base forms of risk retention under the rule, and at the same time accommodates prudent features of existing market structures. The agencies request comment whether the proposal accomplishes both these goals and, if not, what additional

changes the agencies should consider to that end.

#### 3. Representative Sample

##### a. Overview of Original Proposal and Public Comment

The original proposal would have provided that a sponsor could satisfy its risk retention requirement for a securitization transaction by retaining ownership of 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 is equivalent in all material respects to the securitized assets. To ensure that the sponsor retained exposure to substantially the same type of credit risk as investors in the securitized transaction, the sponsor electing to use the representatives sample option would have been required to construct a "designated pool" of assets consisting of at least 1,000 separate assets from which the securitized assets and the assets comprising the representative sample would be drawn and containing no assets other than securitized assets or assets comprising the representative sample. The proposed rule would have required a sponsor to select a sample of assets from the designated pool using a random selection process that would not take into account any characteristics other than unpaid principal balance and to then assess that representative sample to ensure that, for each material characteristic of the assets in the pool, the mean of any quantitative characteristic and the proportion of any categorical characteristic is within a 95 percent two-tailed confidence interval of the mean or proportion of the same characteristics of the assets in the designated pool. If the representative sample did not satisfy this requirement, the proposal stipulated that a sponsor repeat the random selection process until it selected a qualifying sample or opt to use another risk retention form.

The original proposal set forth a variety of safeguards meant to ensure that a sponsor using the representative sample option created the representative pool in conformance with the requirements described above. These included a requirement to obtain a report regarding agreed-upon procedures from an independent public accounting firm describing whether the sponsor has the required procedures in place for selecting the assets to be retained, maintains documentation that clearly identifies the assets in the representative sample, and ensures that the retained assets are not included in the designated pool of any other

securitizations. The proposed rule also would have required, until all of the securities issued in the related securitization had been paid in full or the related issuing entity had been dissolved, that servicing of the assets in the representative sample and in the securitization pool be performed by the same entity under the same contractual standards and that the individuals responsible for this servicing must not be able to identify an asset as being part of the representative sample or the securitization pool. In addition, the sponsor would have been required to make certain specified disclosures.

While some commenters were supportive of the proposal's inclusion of the representative sample option, many commenters were critical of the option. A number of commenters stated that it would be impractical to implement this option for a variety of reasons, including that it would be unworkable with respect to various asset classes, would be subject to manipulation, and was too burdensome with respect to its disclosure requirements. Other commenters recommended that the option be limited for use with automobile loans and other loans that are not identified at origination for sale through securitization. A number of commenters expressed concerns regarding the required size of the designated pool, including that the pool size was too large to be practical, that it would favor larger lenders, and that it would not work well with larger loans, such as jumbo residential mortgage-backed securities and commercial mortgages.

Commenters were generally critical of the proposed requirement for a procedures report, contending that the report would impose costs upon a sponsor without a commensurate benefit. Additionally, commenters representing accounting firms and professionals questioned the value of the procedures report and stated that if not provided to investors in the securitized transaction, the report could run afoul of certain rules governing the professional standards of accountants. Commenters also recommended that the blind servicing requirement of the option be modified to allow for certain activities, such as loss mitigation, assignment of loans to special servicers, disclosure of loan level data, and remittance of funds to appropriate parties.

#### b. Proposed Treatment

The agencies have considered the comments on the representative sample option in the original proposal and are concerned that, based on observations

by commenters, the representative sample option would be difficult to implement and may result in the costs of its utilization outweighing its benefits. Therefore, the agencies are not proposing to include a representative sample option in the re-proposed rule. The agencies believe that the other proposed risk retention options would be better able to achieve the purposes of section 15G, including the standard risk retention option, while reducing the potential to negatively affect the availability and costs of credit to consumers and businesses.

#### Request for Comment

31(a). Should the agencies include a representative sample option as a form of risk retention? 31(b). If so, how should such an option be constructed, consistent with establishing a statistically representative sample? 31(c). What benefits would including such an option provide to the securitization market, investors, borrowers, or others?

#### 4. Asset-Backed Commercial Paper Conduits

##### a. Overview of the Original Proposal and Public Comments

The original proposal included a risk retention option specifically designed for asset-backed commercial paper (ABCP) structures. As explained in the original proposal, ABCP is a type of liability that is typically issued by a special purpose vehicle (commonly referred to as a "conduit") sponsored by a financial institution or other sponsor. The commercial paper issued by the conduit is collateralized by a pool of assets, which may change over the life of the entity. Depending on the type of ABCP program being conducted, the securitized assets collateralizing the ABS interests that support the ABCP may consist of a wide range of assets including automobile loans, commercial loans, trade receivables, credit card receivables, student loans, and other loans. Like other types of commercial paper, the term of ABCP typically is short, and the liabilities are "rolled," or refinanced, at regular intervals. Thus, ABCP conduits generally fund longer-term assets with shorter-term liabilities.<sup>60</sup> The original proposal was designed to take into account the special structures through which some conduits typically issue ABCP, as well as the manner in which participants in the securitization chain of these conduits typically retain exposure to the credit risk of the underlying assets.

<sup>60</sup> See Original Proposal at § \_\_.9.

Under the original proposal, this risk retention option would have been available only for short-term ABCP collateralized by asset-backed securities that were issued or initially sold exclusively to ABCP conduits and supported by a liquidity facility that provides 100 percent liquidity coverage from a banking institution. The option would not have been available to ABCP conduits that lack 100 percent liquidity coverage or ABCP conduits that operate purchased securities or arbitrage programs<sup>61</sup> in the secondary market.

In a typical ABCP conduit, the sponsor of the ABCP conduit approves the originators whose loans or receivables will collateralize the ABS interests that support the ABCP issued by the conduit. Banks can use ABCP conduits that they sponsor to meet the borrowing needs of a bank customer and offer that customer a more attractive cost of funds than a commercial loan or a traditional debt or equity financing. In such a transaction, the customer (an "originator-seller") may sell loans or receivables to an intermediate, bankruptcy remote SPV established by the originator-seller. The credit risk of the receivables transferred to the intermediate SPV then typically is separated into two classes—a senior ABS interest that is purchased by the ABCP conduit and a residual ABS interest that absorbs first losses on the receivables and that is retained by the originator-seller. The residual ABS interest retained by the originator-seller typically is sized with the intention that it be sufficiently large to absorb all losses on the underlying receivables.

The ABCP conduit, in turn, issues short-term ABCP that is collateralized by the senior ABS interests purchased from one or more intermediate SPVs (which are supported by the subordination provided by the residual ABS interests retained by the originator-sellers). The sponsor of this type of ABCP conduit, which is usually a bank or other regulated financial institution or an affiliate or subsidiary of a bank or other regulated financial institution, also typically provides (or arranges for another regulated financial institution or group of financial institution to provide) 100 percent liquidity coverage on the ABCP issued by the conduit. This liquidity coverage typically requires the

<sup>61</sup> Structured investment vehicles (SIVs) and securities arbitrage ABCP programs both purchase securities (rather than receivables and loans) from originators. SIVs typically lack liquidity facilities covering all of these liabilities issued by the SIV, while securities arbitrage ABCP programs typically have such liquidity coverage, though terms are more limited than those of the ABCP conduits eligible for special treatment pursuant to the proposed rule.

support provider to provide funding to, or purchase assets or ABCP from, the ABCP conduit in the event that the conduit lacks the funds necessary to repay maturing ABCP issued by the conduit.

The original proposal included several conditions designed to ensure that this option would be available only to the type of ABCP conduits that do not purchase securities in the secondary market, as described above. For example, this option would have been available only with respect to ABCP issued by an “eligible ABCP conduit,” as defined by the original proposal. The original proposal defined an eligible ABCP conduit as an issuing entity that issues ABCP and that meets each of the following criteria.<sup>62</sup> First, the issuing entity would have been required to have been bankruptcy remote or otherwise isolated for insolvency purposes from the sponsor and any intermediate SPV. Second, the ABS issued by an intermediate SPV to the issuing entity would have been required to be collateralized solely by assets originated by a single originator-seller.<sup>63</sup> Third, all the interests issued by an intermediate SPV would have been required to be transferred to one or more ABCP conduits or retained by the originator-seller. Fourth, a regulated liquidity provider would have been required to enter into a legally binding commitment to provide 100 percent liquidity coverage (in the form of a lending facility, an asset purchase agreement, a repurchase agreement, or similar arrangement) to all of the ABCP issued by the issuing entity by lending to, or purchasing assets or ABCP from, the issuing entity in the event that funds were required to repay maturing ABCP issued by the issuing entity.<sup>64</sup>

<sup>62</sup> See Original Proposal at § \_\_.2 (definition of “eligible ABCP conduit”).

<sup>63</sup> Under the original proposal, an originator-seller would mean an entity that creates financial assets through one or more extensions of credit or otherwise and sells those financial assets (and no other assets) to an intermediate SPV, which in turn sells interests collateralized by those assets to one or more ABCP conduits. The original proposal defined an intermediate SPV as a special purpose vehicle that is bankruptcy remote or otherwise isolated for insolvency purposes that purchases assets from an originator-seller and that issues interests collateralized by such assets to one or more ABCP conduits. See Original Proposal at § \_\_.2 (definitions of “originator-seller” and “intermediate SPV”).

<sup>64</sup> The original proposal defined a regulated liquidity provider as a depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)); a bank holding company (as defined in 12 U.S.C. 1841) or a subsidiary thereof; 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

Under the original proposal, the sponsor of an eligible ABCP conduit would have been permitted to satisfy its base risk retention obligations if each originator-seller that transferred assets to collateralize the ABS interests that supported the ABCP issued by the conduit retained the same amount and type of credit risk as would be required under the horizontal risk retention option under the original proposal as if the originator-seller was the sponsor of the intermediate SPV. Specifically, the original proposal provided that a sponsor of an ABCP securitization transaction could satisfy its base risk retention requirement with respect to the issuance of ABCP by an eligible ABCP conduit if each originator-seller retained an eligible horizontal residual interest in each intermediate SPV established by or on behalf of that originator-seller for purposes of issuing interests to the eligible ABCP conduit. The eligible horizontal residual interest retained by the originator-seller would have been required to equal at least 5 percent of the par value of all interests issued by the intermediate SPV.

Accordingly, each originator-seller would have been required to retain credit exposure to the receivables sold by that originator-seller to support issuance of the ABCP. The originator-seller also would have been prohibited from selling, transferring, or hedging the eligible horizontal residual interest that it is required to retain. This option was designed to accommodate the special structure and features of these types of ABCP programs.

The original proposal also would have imposed certain obligations directly on the sponsor in recognition of the key role the sponsor plays in organizing and operating an eligible ABCP conduit. First, the original proposal provided that the sponsor of an eligible ABCP conduit that issues ABCP in reliance on the option would have been responsible for compliance with the requirements of this risk retention option. Second, the sponsor would have been required to maintain policies and procedures to monitor the originator-sellers’ compliance with the requirements of the proposal.

The sponsor also would have been required to provide, or cause to be provided, to potential purchasers a

thereof; or a foreign bank (or a subsidiary thereof) 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, provided the foreign bank is subject to such standards. See <http://www.bis.org/bcbis/index.htm> for more information about the Basel Capital Accord.

reasonable period of time prior to the sale of any ABCP from the conduit, and to the Commission and its appropriate Federal banking agency, if any, upon request, the name and form of organization of each originator-seller that retained an interest in the securitization transaction pursuant to section 9 of the original proposal (including a description of the form, amount, and nature of such interest), and of the regulated liquidity provider that provided liquidity coverage to the eligible ABCP conduit (including a description of the form, amount, and nature of such liquidity coverage).

Section 15G permits the agencies to allow an originator (rather than a sponsor) to retain the required amount and form of credit risk and to reduce the amount of risk retention required of the sponsor by the amount retained by the originator.<sup>65</sup> In developing the risk retention option for eligible ABCP conduits in the original proposal, the agencies considered the factors set forth in section 15G(d)(2) of the Exchange Act.<sup>66</sup> The original proposal included conditions designed to ensure that the interests in the intermediate SPVs sold to an eligible ABCP conduit would have low credit risk, and to ensure that originator-sellers had incentives to monitor the quality of the assets that are sold to an intermediate SPV and collateralize the ABCP issued by the conduit. In addition, the original proposal was designed to effectuate the risk retention requirements of section 15G of the Exchange Act in a manner that facilitated reasonable access to credit by consumers and businesses through the issuance of ABCP backed by consumer and business receivables. Finally, as noted above, an originator-seller would have been subject to the same restrictions on transferring or hedging the retained eligible horizontal residual interest to a third party as applied to sponsors under the original proposal.

#### b. Comments on the Original Proposal

Commenters generally supported including an option specifically for ABCP structures. Commenters

<sup>65</sup> See 15 U.S.C. 78o–11(c)(1)(G)(iv) and (d) (permitting the Commission and the Federal banking agencies to allow the allocation of risk retention from a sponsor to an originator).

<sup>66</sup> See *id.* at Section 78o–11(d)(2). These factors are whether the assets sold to the securitizer have terms, conditions, and characteristics that reflect low credit risk; whether the form or volume of transactions in securitization markets creates incentives for imprudent origination of the type of loan or asset to be sold to the securitizer; and the potential impact of the risk retention obligations on the access of consumers and businesses to credit on reasonable terms, which may not include the transfer of credit risk to a third party.

expressed concern, however, about several aspects of the option. Many commenters recommended allowing the credit enhancements usually found in ABCP conduit programs (*i.e.*, 100 percent liquidity facilities or program-wide credit enhancement) to qualify as a form of risk retention, in addition to the proposed option, because sponsors that provide this level of protection to their conduit programs are already exposed to as much (or more) risk of loss as a sponsor that holds an eligible horizontal residual interest. Several commenters also requested that the agencies permit originator-sellers to also use the other permitted menu options, such as master trusts.

Commenters generally did not support the restrictions in the definition of “eligible ABCP conduit” in the original proposal because these restrictions would prevent ABCP multi-seller conduits from financing ABS that was collateralized by securitized assets originated by more than one originator. In particular, the restriction that assets held by an intermediate SPV must have been “originated by a single originator-seller” would, as these commenters asserted, preclude funding assets that an originator-seller acquires from a third party or from multiple affiliated originators under a corporate group, which commenters asserted was a common market practice. Many commenters noted that the requirement that all of the interests issued by the intermediate SPV be transferred to one or more ABCP conduits or retained by the originator-seller did not take into account that, in many cases, an intermediate SPV may also sell interests to investors other than ABCP conduits.

Some commenters also observed that the original proposal did not appear to accommodate ABCP conduit transactions where originator-sellers sell their entire interest in the securitized receivables to an intermediate SPV in exchange for cash consideration and an equity interest in the SPV. The SPV, in turn, would hold the retained interest. Therefore, these commenters recommended that the rule permit an originator-seller to retain its interest through its or its affiliate’s ownership of the equity in the intermediate SPV, rather than directly. In addition, a commenter requested that the agencies revise the ABCP option to accommodate structures where the intermediate SPV is the originator. A few commenters requested that the agencies expand the definition of eligible liquidity provider to include government entities, and to allow multiple liquidity providers for one sponsor. Some commenters also criticized the monitoring and disclosure

requirements for the ABCP option in the original proposal. A few commenters recommended that the ABCP option be revised so that ABCP with maturities of up to 397 days could use the ABCP option.

#### c. Proposed ABCP Option

The agencies are proposing an option for ABCP securitization transactions that retains the basic structure of the original proposal with modifications to a number of requirements intended to address issues raised by commenters.<sup>67</sup> As with the original proposal, the proposal permits the sponsor to satisfy its base risk retention requirement if each originator-seller that transfers assets to collateralize the ABCP issued by the conduit retains the same amount and type of credit risk as would be required as if the originator-seller was the sponsor of the intermediate SPV. The agencies continue to believe that such an approach, as modified by the proposal, is appropriate in light of the considerations set forth in section 15G(d)(2) of the Exchange Act.<sup>68</sup> These modifications are intended to allow the ABCP option to accommodate certain of the wider variety of market practices observed in the comments on the original proposal while establishing a meaningful risk retention requirement. In summary, these modifications are designed to permit somewhat more flexibility on behalf of originator-sellers that finance through ABCP conduits extensions of credit they create in connection with their business

<sup>67</sup> As with the original proposal, the proposal permits the sponsor to satisfy its base risk retention requirement if each originator-seller that transfers assets to collateralize the ABCP issued by the conduit retains the same amount and type of credit risk as would be required as if the originator-seller was the sponsor of the intermediate SPV, provided that all other conditions to this option are satisfied. The agencies continue to believe that such an approach, as modified by the proposal, is appropriate in light of the considerations set forth in section 15G(d)(2) of the Exchange Act. *See* note 66, *supra*. In developing the risk retention option for eligible ABCP conduits in the original proposal, the agencies considered the factors set forth in section 15G(d)(2) of the Exchange Act. The proposal include conditions designed to ensure that the interests in the intermediate SPVs sold to an eligible ABCP conduit would have low credit risk, and to ensure that originator-sellers had incentives to monitor the quality of the assets that are sold to an intermediate SPV and collateralize the ABCP issued by the conduit. In addition, the proposal is designed to effectuate the risk retention requirements of section 15G of the Exchange Act in a manner that facilitates reasonable access to credit by consumers and businesses through the issuance of ABCP backed by consumer and business receivables. Finally, as noted above, an originator-seller would be subject to the same restrictions on transferring or hedging the retained interest to a third party as applied to sponsors of securitization transactions.

<sup>68</sup> *See* note 66, *supra*.

operations. The additional flexibility granted under the revised proposal permits affiliated groups of originator-sellers to finance credits through a combined intermediate SPV. It also permits additional flexibility where an originator seller uses an intermediate SPV not only to finance credits through an ABCP conduit, but also other ABS channels, such as direct private placements in the investor market. The proposal also permits additional flexibility to accommodate the structures of intermediate SPVs, such as revolving master trusts and pass-through intermediate special purpose vehicles (ISPVs). Nevertheless, the revised proposal retains the original proposal’s core requirements, including the 100 percent liquidity coverage requirement. The revised proposal also does not accommodate “aggregators” who use ABCP to finance assets acquired in the market; the assets underlying each intermediate SPV must be created by the respective originator-seller.

First, the proposal would introduce the concept of a “majority-owned originator-seller affiliate” (OS affiliate), which would be defined under the proposal as 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. For purposes of this definition, majority control would mean 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). Under the proposal, both an originator-seller and a majority-owned OS affiliate could sell or transfer assets that these entities have originated to an intermediate SPV.<sup>69</sup> However, intermediate SPVs could not acquire assets directly from non-affiliates. This modification addresses the agencies’ concern about asset aggregators that acquire loans and receivables from multiple sources in the market, place them in an intermediate SPV, and issue interests to ABCP conduits. Where, as in

<sup>69</sup> With the majority ownership standard, the agencies are proposing to require a high level of economic identity of interest between firms that are permitted to use a common intermediate SPV as a vehicle to finance their assets. The agencies are concerned that a lower standard of affiliation in this regard could make it more difficult for the conduit sponsor and liquidity provider to understand the credit quality of assets backing the conduit. Moreover, a lower standard of affiliation creates opportunities for an originator-seller to act as an aggregator by securitizing purchased assets through special-purpose vehicles the originator-seller creates and controls for such purposes, and putting the ABS issued by those special-purpose vehicles into the intermediate SPV.

the case of an eligible ABCP conduit, a banking institution provides 100 percent liquidity coverage to the conduit, the Federal banking agencies are concerned that the aggregation model could interfere with the liquidity provider's policies and practices for monitoring and managing the risk exposure of the guarantee. In light of the purposes of section 15G, the Federal banking agencies do not believe that extending the ABCP option to ABCP conduits that are used to finance the purchase and securitization of receivables purchased in the secondary market would consistently help ensure high quality underwriting of ABS.

Second, the proposal would allow for multiple intermediate SPVs between an originator-seller and a majority-owned OS affiliate. As indicated in the comments on the original proposal, there are instances where, for legal or other purposes, there is a need for multiple intermediate SPVs. Under the proposal, an intermediate SPV would be defined to be a direct or indirect wholly-owned affiliate<sup>70</sup> of the originator-seller that is bankruptcy remote or otherwise isolated for insolvency purposes from the eligible ABCP conduit, the originator-seller, and any majority-controlled OS affiliate that, directly or indirectly, sells or transfers assets to such intermediate SPV. The intermediate SPV would be permitted to acquire assets originated by the originator-seller or its majority-controlled OS affiliate from the originator-seller or majority-controlled OS affiliate, or it could also acquire assets or asset-backed securities from another controlled intermediate SPV collateralized solely by securitized assets originated by the originator-seller or its majority-controlled OS affiliate and servicing assets. Finally, intermediate SPVs in structures with multiple intermediate SPVs that do not issue asset-backed securities 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. Finally, under the proposal, all ABS interests held by an eligible ABCP conduit must be issued in a securitization transaction sponsored by an originator-seller and supported by securitized assets originated or created by an originator-seller or one or more majority-owned OS affiliates of the originator-seller.

<sup>70</sup> See proposed rule at § \_\_.2 (definition of "affiliate").

Third, the proposed rule, in contrast to the original proposal, would allow an intermediate SPV to sell asset-backed securities that it issues to third parties other than ABCP conduits. For example, the agencies believe that some originator-sellers operate a revolving master trust to finance extensions of credit the originator-seller creates in connection with its business operations. The master trust sometimes issues a series of ABS backed by an interest in those credits directly to investors through a private placement transaction or registered offering, and other times issues an interest to an eligible ABCP conduit. The proposed rule would accommodate this practice.

Fourth, the proposal would clarify and expand (as compared to the original proposal) the types of collateral that an eligible ABCP conduit could acquire from an originator-seller. Under the proposed definition of "eligible ABCP conduit", a conduit could acquire any of the following types of assets: (1) ABS interests supported by securitized assets originated by an originator-seller or one or more majority-controlled OS affiliates of the originator seller, and by servicing assets;<sup>71</sup> (2) 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-controlled OS affiliate and by servicing assets; and (3) interests in a revolving master trust collateralized solely by assets originated by an originator-seller or majority-controlled OS affiliate; and by servicing assets.<sup>72</sup>

Consistent with this principle, the agencies seek to clarify that the ABS interests acquired by the conduit could not be collateralized by securitized assets otherwise purchased or acquired by the intermediate SPV's originator-seller, majority-controlled OS affiliate, or by the intermediate SPV from unaffiliated originators or sellers. The ABS interests also would have to be acquired by the ABCP conduit in an initial issuance by or on behalf of an

<sup>71</sup> The purpose of this clarification is to allow originator-sellers certain additional flexibility in structuring their participation in eligible ABCP conduits, while retaining the core principle that the assets being financed have been originated by the originator-seller or a majority-controlled OS affiliate, not purchased and aggregated.

<sup>72</sup> The definition of "servicing assets" is discussed in Part II.B of this Supplementary Information. The agencies are allowing an ABCP conduit to hold servicing assets, and thus acknowledge the kinds of rights and assets that a typical ABCP conduit needs to have in order to conduct the activities required in a securitization.

intermediate SPV, (1) directly from the intermediate SPV, (2) from an underwriter of the securities issued by the intermediate SPV, or (3) from another person who acquired the securities directly from the intermediate SPV. In addition, the ABCP conduit would have to be collateralized solely by asset-backed securities acquired by the ABCP conduit in an initial issuance by or on behalf of an intermediate SPV directly from the intermediate SPVs, from an underwriter of the securities issued by the intermediate SPV, or from another person who acquired the securities directly from the intermediate SPV and servicing assets. Because eligible ABCP conduits can only purchase ABS interests in an initial issuance, eligible ABCP conduits may not aggregate ABS interests by purchasing them in the secondary market.

Fifth, in response to comments on the original proposal that an originator-seller should be able to use a wider variety of risk retention options, the proposal would expand the retention options available to the originator-seller. Under the proposed rule, an eligible ABCP conduit would satisfy its risk retention requirements if, with respect to each asset-backed security the ABCP conduit acquires from an intermediate SPV, the originator-seller or majority-controlled OS affiliate held risk retention in the same form, amount, and manner as would be required using the standard risk retention or revolving asset master trust options. Thus, in the example above of an originator-seller that finances credits through a revolving master trust, the originator-seller could retain risk in the form of a seller's interest meeting the requirements of the revolving master trust provisions of the proposed rule.

Sixth, consistent with the original proposal, the proposal requires that a regulated liquidity provider must have entered into a legally binding commitment to provide 100 percent liquidity coverage (in the form of a lending facility, an asset purchase agreement, a repurchase agreement, or similar arrangement) of all the ABCP issued by the issuing entity by lending to, or purchasing assets from, the issuing entity in the event that funds are required to repay maturing ABCP issued by the issuing entity. The proposal clarifies that 100 percent liquidity coverage means that, in the event that the ABCP conduit is unable for any reason to repay maturing ABCP issued by the issuing entity, the total amount for which the liquidity provider may be obligated is equal to 100 percent of the amount of ABCP outstanding 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 coverage that only funds performing receivables or performing ABS interests will not meet the requirements of the ABCP option.

d. Duty To Monitor and Disclosure Requirements

Consistent with the original proposal, the agencies are proposing that the sponsor of an eligible ABCP conduit would continue to be responsible for compliance. Some commenters on the original proposal requested that the agencies replace the monitoring obligation with a contractual obligation of an originator-seller to maintain compliance. However, the agencies believe that the sponsor of an ABCP conduit is in the best position to monitor compliance by originator-sellers. Accordingly, the proposal would continue to require the sponsor of an ABCP conduit to monitor compliance by an originator-seller.

e. Disclosure Requirements

The agencies also are proposing disclosure requirements that are similar to those in the original proposal, with two changes. First, the agencies are proposing to remove the requirement that the sponsor of the ABCP conduit disclose the names of the originator-sellers. The proposal would continue to require the sponsor of an ABCP conduit to provide to each purchaser of ABCP the name and form of organization of the regulated liquidity provider that provides liquidity coverage to the eligible ABCP conduit, including a description of the form, amount, and nature of such liquidity coverage, and notice of any failure to fund. In addition, with respect to each ABS interest held by the ABCP conduit, the sponsor of the ABCP conduit would be required to provide the asset class or brief description of the underlying receivables for each ABS interest, the standard industrial category code (SIC Code) for the originator-seller or majority-controlled OS affiliate that will retain (or has retained) pursuant to this section an interest in the securitization transaction, and a description of the form, amount (expressed as a percentage and as a dollar amount (or corresponding amount in the foreign currency in which the ABS are issued, as applicable) of the fair value of all ABS interests issued in the securitization transaction. Finally, an ABCP conduit sponsor relying on the

ABCP option would be required to provide, or cause to be provided, upon request, to the Commission and its appropriate Federal banking agency, if any, in writing, all of the information required to be provided to investors and the name and form of organization of each originator-seller or majority-controlled OS affiliate that will retain (or has retained) an interest in the underlying securitization transactions.

Second, a sponsor of an ABCP conduit would be required to promptly notify investors, the Commission, and its appropriate Federal banking agency, if any, in writing of (1) the name and form of organization of any originator-seller that fails to maintain its risk retention as required by the proposed rule and the amount of asset-backed securities issued by an intermediate SPV of such originator-seller and held by the ABCP conduit; (2) the name and form of organization of any originator-seller that hedges, directly or indirectly through an intermediate SPV, its risk retention in violation of its risk retention requirements and the amount of asset-backed securities issued by an intermediate SPV of such originator-seller and held by the ABCP conduit; and (3) and any remedial actions taken by the ABCP conduit sponsor or other party with respect to such asset-backed securities. In addition, the sponsor of an ABCP conduit would be required to take other appropriate steps upon learning of a violation by an originator-seller of its risk retention obligations including, as appropriate, curing any breach of the requirements, or removing from the eligible ABCP conduit any asset-backed security that does not comply with the applicable requirements. To cure the non-compliance of the non-conforming asset, the sponsor could, among other things, purchase the non-conforming 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 under the underlying transaction documents (assuming the sponsor negotiated such a term) and accelerate the repayment of the underlying assets.

f. Other Items

In most cases, the sponsor of the ABCP issued by the conduit will be the bank or an affiliate of the bank that organizes the conduit. The agencies note that the use of the ABCP option by the sponsor of an eligible ABCP conduit would not relieve the originator-seller from its independent obligation to comply with its own risk retention obligations under the revised proposal, if any. In most, if not all, cases, the originator-seller will be the sponsor of

the asset-backed securities issued by an intermediate SPV and will therefore be required to hold an economic interest in the credit risk of the assets collateralizing the asset-backed securities issued by the intermediate SPV. The agencies also note that a sponsor of an ABCP conduit would not be limited to using the ABCP option to satisfy its risk retention requirements. An ABCP conduit sponsor could rely on any of the risk retention options described in section 4 of the proposed rule.

The agencies are proposing definitions of “ABCP” and “eligible liquidity provider” that are the same as the definitions in the original proposal. The agencies believe it would be inappropriate to expand the ABCP option to commercial paper that has a term of over nine months, because a duration of nine months accommodates almost all outstanding issuances and the bulk of those issuances have a significantly shorter term of 90 days or less. In addition, the agencies have not expanded the definition of eligible liquidity provider to include sovereign entities. The agencies do not believe that prudential requirements could be easily designed to accommodate a sovereign entity that functions as a liquidity provider to an ABCP conduit.

Request for Comments

32(a). To the extent that the proposed ABCP risk retention option does not reflect market practice, how would modifying the proposal help ensure high quality underwriting of ABCP? 32(b). What structural or definitional changes to the proposal would be appropriate, including but not limited to any changes to the proposed definitions of 100 percent liquidity coverage, eligible ABCP conduit, intermediate SPV, majority-owned OS affiliate, originator-seller, and regulated liquidity provider? 32(c). Do ABCP conduits typically have 100 percent liquidity coverage as defined in the proposal? 32(d). What percentage of ABCP conduits and what percentage of ABCP currently outstanding was issued by such conduits?

33(a). Do ABCP conduits typically only purchase assets directly from intermediate SPVs (*i.e.*, that meet the requirements of the proposal)? 33(b). What percentage of ABCP currently outstanding was issued by such conduits?

34(a). Do ABCP conduits typically purchase receivables directly from customers, rather than purchasing ABS interests from SPVs sponsored by customers? 34(b). What percentage of ABCP currently outstanding was issued

by such conduits? 34(c). Is the requirement that an ABCP conduit relying on this option may not purchase receivables directly from the originator appropriate? 34(d). Why or why not?

35(a). Is the requirement that an ABCP conduit relying on this option may not purchase ABS interests in the secondary market appropriate? 35(b). Why or why not? 35(c). Does the proposed ABCP option appropriately capture assets that are acquired through business combinations?

36(a). Do ABCP conduits typically purchase corporate debt securities on a regular or occasional basis? 36(b). What percentage of ABCP currently outstanding was issued by such conduits?

37(a). Do ABCP conduits typically purchase ABS in the secondary market on a regular or occasional basis? 37(b). What percentage of ABCP currently outstanding was issued by such conduits?

38. With respect to ABCP conduits that purchase assets that do not meet the requirements of the proposal, what percentage of those ABCP conduits' assets do not meet the requirements?

39(a). Should the agencies allow multiple eligible liquidity providers for purposes of the ABCP risk retention options? 39(b). If so, should this be limited to special circumstances? 39(c). Should the agencies allow a liquidity provider to provide liquidity coverage with respect to a specific ABS interest?

40(a). Does the definition of majority-owned OS affiliate appropriately capture companies that are affiliated with an originator-seller? 40(b). Why or why not?

41. Should the rule require disclosure of the originator seller in the case of noncompliance by the originator seller?

42(a). Should the rule also require disclosure to investors in ABCP in all cases of violation of this section? 42(b). Why or why not? 42(c). If so, should the rule prescribe how such disclosure be made available to investors?

43. Are there other changes that should be made to disclosure provisions?

44. Should the rule provide further clarity as to who will be deemed a sponsor of ABCP issued by an ABCP conduit?

45(a). Should there be a supplemental phase-in period (beyond the delayed effective dates in 15 U.S.C. 78o-11(i)) for existing ABCP conduits that do not meet the proposed definition of eligible ABCP conduit? 45(b). Why or why not? 45(c). If so, what would be the appropriate limit (e.g., up to 10 percent of the assets in the ABCP conduit could be nonconforming), and what would be the

appropriate time period(s) for conformance (e.g., up to two years)?

## 5. Commercial Mortgage-Backed Securities

### a. Overview of the Original Proposal and Public Comments

Section 15G(c)(1)(E) of the Exchange Act (15 U.S.C. 78o-11(c)(1)(E)) provides that, with respect to CMBS, the regulations prescribed by the agencies may provide for retention of the first-loss position by a third-party purchaser that specifically negotiates for the purchase of such first-loss position, holds adequate financial resources to back losses, provides due diligence on all individual assets in the pool before the issuance of the asset-backed securities, and meets the same standards for risk retention as the Federal banking agencies and the Commission require of the securitizer. In light of this provision and the historical market practice of third-party purchasers acquiring first-loss positions in CMBS transactions, the agencies originally proposed to permit a sponsor of ABS that is collateralized by commercial real estate loans to meet its risk retention requirements if a third-party purchaser acquired an eligible horizontal residual interest in the issuing entity.<sup>73</sup> The acquired interest would have had to take the same form, amount, and manner as the sponsor would have been required to retain under the horizontal risk retention option. The CMBS risk retention option would have been available only for securitization transactions where commercial real estate loans constituted at least 95 percent of the unpaid principal balance of the assets being securitized and where six proposed requirements were met:

(1) The third-party purchaser retained an eligible horizontal residual interest in the securitization in the same form, amount, and manner as would be required of the sponsor under the horizontal risk retention option;

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

(3) The third-party purchaser performed a review of the credit risk of

each asset in the pool prior to the sale of the asset-backed securities;

(4) The third-party purchaser could not be affiliated with any other party to the securitization transaction (other than investors) or have control rights in the securitization (including, but not limited to acting as servicer or special servicer) that were not collectively shared by all other investors in the securitization;

(5) The sponsor provided, or caused to be provided, to potential purchasers certain information concerning the third-party purchaser and other information concerning the transaction; and

(6) Any third-party purchaser acquiring an eligible horizontal residual interest under the CMBS option complied with the hedging, transfer and other restrictions applicable to such interest under the proposed rules as if the third-party purchaser was a sponsor who had acquired the interest under the horizontal risk retention option.

As stated in the original proposal, these requirements were designed to help ensure that the form, amount and manner of the third-party purchaser's risk retention would be consistent with the purposes of section 15G of the Exchange Act.

Generally, commenters supported the ability of sponsors to transfer credit risk to third-party purchasers. One commenter stated that the CMBS option acknowledged the mandate of section 941 of the Dodd-Frank Act and the recommendations of the Federal Reserve Board by providing much needed flexibility to the risk retention rules and recognized the impact and importance of the third-party purchaser in the CMBS market. Some commenters, however, believed the proposed criteria for the option would discourage the use of the option or render the option unworkable. In particular, one commenter raised concerns with the restrictions on financing and hedging of the B-piece, the restrictions on the transfer of such interest for the life of the transaction, restrictions on servicing and control rights including the introduction of an operating advisor, and requirements related to the disclosure of the B-piece purchase price would likely discourage the use of the CMBS option.

In response to the agencies' question in the original proposal as to whether a third-party risk retention option should be available to other asset classes, commenters' views were mixed. Some commenters expressed support for allowing third parties to retain the risk in other asset classes, with other commenters supporting a third-party

<sup>73</sup> Such third-party purchasers are commonly referred to in the CMBS market as "B-piece buyers" and the eligible horizontal residual interest is commonly referred to as the "B-piece."

option for RMBS and another commenter suggesting the option be made available to any transaction in which individual assets may be significant enough in size to merit the individual review required of a third-party purchaser.

The agencies believe that a third-party purchaser that specifically negotiates for the purchase of a first-loss position is a common feature of commercial mortgage securitizations that is generally not found in other asset classes. For this reason, section 15G(c)(1)(E)(ii) of the Exchange Act specifically permits the agencies to create third-party risk retention for commercial mortgage securitizations. However, the agencies believe there is insufficient benefit to market liquidity to justify an expansion of third-party risk retention to other asset classes, and propose to maintain the more direct alignment of incentives achieved by requiring the sponsor to retain risk for the other asset classes not covered by section 15G(c)(1)(E)(ii).

The agencies also received many comments with respect to the specific conditions of the CMBS option in the original proposal. In this proposed rule, the CMBS option is similar to that of the original proposal, but incorporates a number of key changes the agencies believe are appropriate in response to concerns raised by commenters. These are discussed below.

#### b. Proposed CMBS Option

##### i. Number of Third-Party Purchasers and Retention of Eligible Interest

Under the original proposal, only one third-party purchaser could retain the required risk retention interest. Additionally, the third-party purchaser would have been required to retain an eligible horizontal residual interest in the securitization in the same form, amount and manner as would be required of the sponsor under the horizontal retention option. The proposed CMBS option was not designed to permit a third-party purchaser to share the required risk retention with the sponsor.

Many commenters on the original proposal requested flexibility in satisfying the CMBS option through the sharing of risk retention between sponsors and third-party purchasers, as well as among multiple third-party purchasers. In particular, some commenters noted that allowing such flexibility would be consistent with how the proposed rule would allow a sponsor to choose to retain a vertical and horizontal retention piece to share

the risk retention obligation with an originator.

The agencies considered the comments on the original proposal carefully and believe that some additional flexibility for the CMBS risk retention option would be appropriate. Accordingly, under the proposed rule, the agencies would allow two (but no more than two) third-party purchasers to satisfy the risk retention requirement through the purchase of an eligible horizontal residual interest (as defined under the proposed rule). Each third-party purchaser's interest would be required to be *pari passu* with the other third-party purchaser's interest, so that neither third-party purchaser's losses are subordinate to the other's losses. The agencies do not believe it would be appropriate to allow more than two third-party purchasers to satisfy the risk retention requirement for a single transaction, because it could dilute too much the incentives generated by the risk retention requirement to monitor the credit quality of the commercial mortgages in the pool.

The agencies are also revising the CMBS option to clarify that, when read together with the revisions that have been made to the standard risk retention requirements, the eligible horizontal residual interest held by the third-party purchasers can be used to satisfy the standard risk retention requirements, either by itself as the sole credit risk retained or in combination with a vertical interest held by the sponsor. The agencies believe this flexibility increases the likelihood that third-party purchasers will assume risk retention obligations. The agencies further believe that the interests of the third-party purchaser and other investors are aligned through other provisions of the proposed CMBS option, namely the Operating Advisor provisions and disclosure provisions discussed below.

##### ii. Third-Party Purchaser Qualifying Criteria

In the original proposal, the agencies did not propose qualifying criteria for third-party purchasers related to the third-party purchaser's experience or financial capabilities.

One commenter proposed that only "qualified" third-party purchasers be permitted to retain the risk under the CMBS option, with such qualifications based on certain pre-determined criteria of experience, financial analysis capability, capability to direct the special servicer and certain financial capabilities to sustain losses. Another commenter requested that the final rule require third-party purchasers to be independent from special servicers.

Consistent with the original proposal, the agencies are not proposing to add specific qualifying criteria for third-party purchasers. The agencies believe that investors in the business of purchasing B-piece interests in CMBS transactions, who are typically interested in acquiring special servicing rights in such transactions, likely have the requisite experience and capabilities to make an informed decision regarding their purchases. Furthermore, the agencies continue to propose disclosure requirements with respect to the identity and experience of third-party purchasers in the transaction, which will alert investors in a CMBS transaction as to the experience of third-party purchasers and other material information necessary to make an informed investment decision. Additionally, based generally on comments the agencies have received, the agencies have not added a requirement that third-party purchasers be independent from special servicers since the acquisition of special servicing rights is a primary reason why third-party purchasers are willing to purchase the B-piece in the CMBS transactions. Such an independence requirement would adversely affect the willingness of third-party purchasers to assume the risk retention obligations in CMBS transactions.

##### iii. Composition of Collateral

Consistent with the original proposal, the agencies are restricting the third-party purchaser option to securitization transactions collateralized by commercial real estate loans. However, the original proposal allowed up to 5 percent of the collateral to be other types of assets, in order to accommodate assets other than loans that are typically needed to administer a securitization. Since then, the agencies have added the servicing assets definition to the proposed rule, to accommodate these kinds of assets.<sup>74</sup> Accordingly, the agencies are eliminating the 95 percent test and revising the collateral restriction to cover securitization transactions collateralized by commercial real estate loans and servicing assets.

##### iv. Source of Funds

The original proposal would have required that the third-party purchaser pay for its eligible horizontal residual interest in cash, and would have prohibited the third-party purchaser from obtaining financing, directly or

<sup>74</sup> The definition of "servicing assets" is discussed in Part II.B of this Supplementary Information.

indirectly, for the purchase of such interest from any party to the securitization transaction other than an investor.

A few commenters supported the proposed limitation on financing, while another commenter recommended that no distinction be made between the sponsor's ability to finance its risk retention interest compared to third-party purchasers. Several commenters requested clarification on what "indirect" financing means under the proposal and requested that the final rule not prohibit the third-party purchaser from obtaining financing from a party for an unrelated transaction.

The agencies are re-proposing this condition consistent with the original proposal. The limitation on obtaining financing would apply only to financings for the purchase of the B-piece in a specific CMBS transaction and only where the financing provider is another party to that same CMBS transaction. The agencies are clarifying that the financing provider restriction would include affiliates of the other parties to the CMBS transaction. This limitation would not restrict third-party purchasers from obtaining financing from a transaction party for a purpose other than purchasing the B-piece in the transaction; provided that none of such financing is later used to purchase the B-piece, which would be an indirect financing of the B-piece. Nor would third-party purchasers be restricted from obtaining financing from a person that is not a party to the specific transaction, unless that person had some indirect relationship with a party to the transaction, such as a parent-subsidiary relationship or a subsidiary-subsidiary relationship under a parent company (subject to the required holding period and applicable hedging restrictions). The use of the term indirect financing is meant to ensure that these types of indirect relationships are prohibited under the financing limitations of the rule.

#### v. Review of Assets by Third-Party Purchaser

Under the original proposal, a third-party purchaser would have been required to conduct a review of the credit risk of each securitized asset prior to the sale of the ABS that includes, at a minimum, a review of the underwriting standards, collateral, and expected cash flows of each loan in the pool. Most commenters addressing this issue generally supported the proposed condition that a third-party purchaser must separately examine each asset in the pool. Specifically, one commenter noted that this level of review is

currently the industry standard and is a clear indication of the strength of the credit review process for CMBS transactions.

The agencies are proposing this condition again with only minor changes to indicate, in the event there is more than one third-party purchaser in a transaction, that each third-party purchaser would be required to conduct an independent review of the credit risk of each CMBS asset.

#### vi. Operating Advisor

##### (1) Affiliation and Control Rights

The original proposal included a condition of the CMBS option intended to address the potential conflicts of interest that can arise when a third-party purchaser serves as the "controlling class" of a CMBS transaction. This condition would have prohibited a third-party purchaser from (1) being affiliated with any other party to the securitization transaction (other than investors); or (2) having control rights in the securitization (including, but not limited to acting as servicer or special servicer) that are not collectively shared by all other investors in the securitization. The proposed prohibition of control rights related to servicing would have been subject to an exception from this condition, however, only if the underlying securitization transaction documents provided for the appointment of an independent operating advisor ("Operating Advisor") with certain powers and responsibilities that met certain criteria. The proposed criteria were: (1) The Operating Advisor is not affiliated with any other party to the securitization, (2) the Operating Advisor does not directly or indirectly have any financial interest in the securitization other than in fees from its role as Operating Advisor, and (3) the Operating Advisor is required to act in the best interest of, and for the benefit of, investors as a collective whole. The original proposal would have required that an independent Operating Advisor be appointed if the third-party purchaser was acting as, or was affiliated with, a servicer for any of the securitized assets and had control rights related to such servicing.

##### (2) Operating Advisor Criteria and Responsibilities

The agencies received many comments with respect to the criteria in the original proposal for the Operating Advisor, as well as with respect to the Operating Advisor's required responsibilities.

Commenters had mixed views concerning when the rule should

require an Operating Advisor and whether the Operating Advisor should play an active role while the third-party purchaser is the "controlling class." There was a comment supporting the proposed requirement that an Operating Advisor be included when the third-party purchaser is affiliated with and controls the special servicing function of the transaction. Some commenters supported the inclusion of an Operating Advisor in all CMBS transactions. Other commenters supported a dormant role for the Operating Advisor while the third-party purchaser was the "controlling class," and the Operating Advisor's power would be triggered when such purchaser was no longer the controlling class (typically when the third-party purchaser's interest is reduced to less than 25 percent of its original principal balance after taking into account appraisal reductions). Some of these commenters asserted that the introduction of an Operating Advisor may support the interests of the senior investors at the expense of the third-party purchaser, thereby adversely affecting the willingness of third-party purchasers to assume the risk retention obligations. Further, commenters stated that the Operating Advisor would add layers of administrative burden on an already highly structured CMBS framework and make servicing and workouts for the underlying loans more difficult and expensive, thereby reducing returns. Finally, some commenters stated that oversight is unnecessary while the third-party purchaser continues to have an economic stake in the transaction because third-party purchasers are highly incentivized to discharge their servicing duties in a manner that maximizes recoveries. One of these commenters noted that this is its current approach and is working to the satisfaction of both investment grade investors and third-party purchasers. Some commenters recommended a framework whereby the Operating Advisor would be involved immediately but its role would depend on whether the third-party purchaser was the controlling class.

Additionally, some commenters specifically requested that the Operating Advisor's authority apply only to the special servicer (instead of all servicers as originally proposed) for three reasons. First, the special servicer has authority or consent rights with respect to all material servicing actions and defaulted loans, whereas the master servicer has very little discretion because its servicing duties are typically set forth in detail in the pooling and

servicing agreement and its authority to modify loans is limited. Moreover, any control right held by a third-party purchaser with respect to servicing is typically exercised through the special servicer and the third-party purchaser does not generally provide any direct input into master servicer decisions.

Second, the B-piece termination right is another structural feature of CMBS transactions that applies to special servicers but not to master servicers. The third-party purchaser's right to terminate and replace the special servicer without cause is one method of control by the third-party purchaser over special servicing. The master servicer, however, is not subject to this termination without cause. The master servicer typically can be terminated by the trustee only upon the occurrence of one of the negotiated events of default with respect to the master servicer. In the event of such a default, holders of ABS evidencing a specified percentage of voting rights (25 percent in many deals) of all certificates can direct the trustee to take such termination action.

Third, an Operating Advisor's right to remove the master servicer may be problematic for the master servicer's servicing rights assets. Master servicers usually purchase their servicing rights from the sponsors in the securitization and these rights retain an ongoing value. Therefore, any termination rights beyond those based on negotiated events of default jeopardize the value of the master servicer's servicing asset.

Based on comments received, the agencies acknowledge that third-party purchasers often are, or are affiliated with, the special servicers in CMBS transactions. Because of this strong connection between third-party purchasers and the special servicing rights in CMBS transactions, the agencies are proposing to limit application of the Operating Advisor provisions to special servicers, rather than any affiliated servicers as originally proposed in the original proposal. Consequently, the agencies are also proposing a revised CMBS option to require as a separate condition the appointment of an Operating Advisor in all CMBS transactions that rely on the CMBS risk retention option.

As stated in the original proposal, the agencies believe that the introduction of an independent Operating Advisor provides a check on third-party purchasers by limiting the ability of third-party purchasers to manipulate cash flows through special servicing. In approving loans for inclusion in the securitization, third-party purchasers ideally will be mindful of the limits on their ability to offset the consequences

of poor underwriting through servicing tactics if loans become troubled, thereby providing a stronger incentive for third-party purchasers to be diligent in assessing the credit quality of pool assets at the time of securitization.

Because the agencies are proposing that an Operating Advisor be required for all CMBS transactions relying on the CMBS option, the prohibition on third-party purchasers having control rights related to servicing is no longer necessary and has been removed.

### (3) Operating Advisor Independence

The original proposal would have prohibited the Operating Advisor from being affiliated with any party to the transaction and from having, directly or indirectly, any financial interest in the transaction other than its fees from its role as Operating Advisor.

An investor commenter supported complete independence for the Operating Advisor, reasoning that the Operating Advisor should not in any way be conflicted when representing all holders of ABS. Other commenters did not support the independence criteria, instead proposing to rectify any conflicts of interest through disclosure. One of these commenters commented that it would be counter-productive to preclude current Operating Advisors from serving in that capacity in the future, as such a framework would leave only smaller firms with little or no experience as the only eligible candidates and could result in diminution of available investment capital. Independence concerns should instead be addressed by the Operating Advisor's disclosure at the time it initiates proceedings to replace a special servicer, of whether the Operating Advisor has any conflicts of interest.

Consistent with the original proposal, the CMBS option in the proposed rule would require that the Operating Advisor not be affiliated with other parties to the securitization transaction. Also consistent with the original proposal, the Operating Advisor would be prohibited from having, directly or indirectly, any financial interest in the securitization transaction other than fees from its role as Operating Advisor and would be required to act in the best interest of, and for the benefit of, investors as a collective whole. As stated above, the agencies believe that an independent Operating Advisor is a key factor in providing a check on third-party purchasers and special servicers, thereby protecting investors' interests.

### (4) Qualifications of the Operating Advisor

In the original proposal, the agencies did not propose qualifications for the Operating Advisor other than independence from other parties to the securitization transaction.

One commenter recommended that the final rule include eligibility requirements for Operating Advisors, such as requiring an Operating Advisor to have an existing servicing platform (not necessarily rated); have at least 25 full time employees; have at least \$25 million in capital; and have some metric for assuring that the Operating Advisor will have an ongoing real estate market presence and the in-house expertise necessary to effectively carry out their responsibilities. Another commenter requested clarification regarding the qualifications of an Operating Advisor but did not expressly advocate for or against particular qualifications.

Based in part on comments received, the agencies are proposing certain general qualifications for the Operating Advisor. Under the proposed rule, the underlying transaction documents must provide for standards with respect to the Operating Advisor's experience, expertise and financial strength to fulfill its duties and responsibilities under the applicable transaction documents over the life of the securitization transaction. Additionally, the transaction documents must describe the terms of the Operating Advisor's compensation with respect to the securitization transaction.

The agencies do not believe it is necessary to mandate specific minimum levels of experience, expertise and financial strength for Operating Advisors in CMBS transactions relying on the CMBS option. Rather, the agencies believe that CMBS transaction parties should be permitted to establish Operating Advisor qualification standards and compensation in each transaction. By requiring disclosure to investors of such qualification standards, how an Operating Advisor satisfies such standards, and the Operating Advisor's related compensation, the proposed rule provides investors with an opportunity to evaluate the Operating Advisor's qualifications and compensation in the relevant transaction.

### (5) Role of the Operating Advisor

Under the original proposal, the duties of the Operating Advisor were generally to (1) act in the best interest of investors as a collective whole, (2) require the servicer for the securitized assets to consult with the Operating Advisor in connection with, and prior

to, any major decision in connection with servicing, which would include any material loan modification and foreclosures and acquisitions of properties, and (3) review the actions of the affiliated servicer and report to investors and the issuing entity on a periodic basis.

With respect to the role of the Operating Advisor in the original proposal, comments were mixed. Investor commenters generally supported the consultative role given to Operating Advisors under the original proposal. Issuers and industry association commenters did not support such role and believed that the powers granted to the Operating Advisor under the original proposal were too broad. In particular, these commenters generally did not support the proposed requirement that the servicer consult with the Operating Advisor prior to any major servicing decision.

Another commenter recommended a framework such that after the change-in-control event (that is, when the B-piece position is reduced to less than 25 percent of its original principle balance), the Operating Advisor's role would be that of a monitoring role and investigate claims of special servicer noncompliance when initiated by a specified percentage of investors, and provide its findings on a regular basis to CMBS investors, the sponsor and the servicers.

A trade association commenter, supported by two other commenters, preferred an approach in which the Operating Advisor's role would be reactive while the third-party purchaser is the controlling class, and become proactive when the third-party purchaser is no longer the controlling class. Under this commenter's approach, the rule would provide that the third-party purchaser is no longer in control if the sum of principal payments, appraisal reductions and realized losses have reduced the third-party purchaser's initial positions to less than 25 percent of its original face amount.

Consistent with the original proposal, the proposed rule would require consultation with the Operating Advisor in connection with, and prior to, any major investing decision in connection with the servicing of the securitized assets. However, based on comments received, the consultation requirement only applies to special servicers and only takes effect once the eligible horizontal residual interest held by third-party purchasers in the transaction has a principal balance of 25 percent or less of its initial principal balance.

#### (6) Operating Advisor's Evaluation of Servicing Standards

The original proposal would have included a requirement that the Operating Advisor be responsible for reviewing the actions of any affiliated servicer and issue a report evaluating whether the servicer is operating in compliance with any standard required of the servicer, as provided in the applicable transaction documents.

One trade association commenter recommended that the rule establish the standard by which the Operating Advisor evaluates the special servicer. It stated that one such standard would be to include language in the pooling and servicing agreement or similar transaction document that would require the special servicer to maximize the net present value of the loan without consideration of the impact of such action on any specific class of ABS. However, as this trade association was unresponsive of requiring the servicer to consult with the Operating Advisor prior to any material workout, it also stated that an alternative to actually including the servicing standard would be for the Operating Advisor to monitor all loan workouts and, if the special servicer is not meeting the stated standard, the Operating Advisor could then take the appropriate action.

The agencies are proposing that the CMBS option require the Operating Advisor to have adequate and timely access to information and reports necessary to fulfill its duties under the transaction documents. Further, the proposed rule would require the Operating Advisor to be responsible for reviewing the actions of the special servicer, reviewing all reports made by the special servicer to the issuing entity, reviewing for accuracy and consistency calculations made by the special servicer within the transaction documents, and issuing a report to investors and the issuing entity on special servicer's performance.

#### (7) Servicer Removal Provisions

Under the original proposal, the Operating Advisor would have had the authority to recommend that a servicer be replaced if it determined that the servicer was not in compliance with the servicing standards outlined in the transaction documents. This recommendation would be submitted to investors and would be approved unless a majority of each class of investors voted to retain the servicer.

Many commenters were of the view that the rule granted too much authority to the Operating Advisor in regards to the removal of a servicer. As discussed

above, many commenters believed that the Operating Advisor's authority should only apply to special servicers. Following on this point, many commenters commented that the special servicer should be removed only upon the affirmative vote of ABS holders (instead of a negative vote as originally proposed).

One commenter suggested that the special servicer removal process should be negotiated among the CMBS transaction parties and specified in the pooling and servicing agreement or similar transaction document. In this scenario, the special servicer would have the opportunity to explain its conduct, the Operating Advisor would be required to publicly explain its rationale for recommending special servicer removal, and investors in non-controlling classes would vote in the affirmative for special servicer removal. Another commenter proposed that an Operating Advisor's recommendation to remove a special servicer would have to be approved by two-thirds of all ABS holders voting as a whole, or through an arbitration mechanism. Another commenter proposed that a minimum of 5 percent of all ABS holders based on par dollar value of holdings be required for quorum, and decisions would be adopted with the support of a simple majority of the dollar value of par of quorum. Another commenter advocated removal only after the third-party purchaser is no longer the controlling class.

After considering comments that the servicer removal provision should only apply to special servicers, the agencies are proposing that the Operating Advisor's authority to recommend removal and replacement would be limited to special servicers. Additionally, based on comments received, the agencies are proposing that the actual removal of the special servicer would require the affirmative vote of a majority of the outstanding principal balance of all ABS interests voting on the matter, and require a quorum of 5 percent of the outstanding principal balance of all ABS interests.

Because of the agencies' belief that the introduction of an independent Operating Advisor provides a check on third-party purchasers by limiting the ability of third-party purchasers to manipulate cash flows through special servicing, the agencies believe that the removal of the special servicer should be independent of whether the third-party purchaser is the controlling class in the securitization transaction or similar considerations. The proposed affirmative majority vote and quorum requirements are designed to provide

additional protections to investors in this regard.

#### c. Disclosures

Under the original proposal, the sponsor would have been required to provide, or cause to be provided, to potential purchasers and federal supervisors certain information concerning the third-party purchaser and other information concerning the CMBS transaction, such as the third-party purchaser's name, the purchaser's experience investing in CMBS, and any other material information about the third-party purchaser deemed material to investors in light of the particular securitization transaction.

Additionally, a sponsor would have been required to disclose to investors the amount of the eligible horizontal residual interest that the third-party purchaser will retain (or has retained) in the transaction (expressed as a percentage of the fair value of all ABS interests issued in the securitization transaction and the dollar amount of the fair value of such ABS interests); the purchase price paid for such interest; the material terms of such interest; the amount of the interest that the sponsor would have been required to retain if the sponsor had retained an interest in the transaction; the material assumptions and methodology used in determining the aggregate amount of ABS interests of the issuing entity; and certain information about the representations and warranties concerning the securitized assets.

While commenters generally supported the proposed disclosure requirements, many commenters raised concerns about specific portions of these requirements.

Under the original proposal, the sponsor would have been required to disclose to investors the name and form of organization of the third-party purchaser as well as a description of the third-party purchaser's experience in investing in CMBS. The original proposal also solicited comment as to whether disclosure concerning the financial resources of the third-party purchaser would be necessary in light of the requirement that the third-party purchaser fund the acquisition of the eligible horizontal residual interest in cash, without direct or indirect financing from a party to the transaction. Some commenters supported these proposed requirements, while others did not.

Under the original proposal, a third-party purchaser would have been required to disclose the actual purchase price paid for the retained residual interest. Several commenters did not

support requiring purchase price disclosure. These commenters noted that price disclosure raises confidentiality concerns and could reveal the purchaser's price parameters to its competitors. These commenters provided suggestions for maintaining the confidentiality of such information or alternatives to actual disclosure of prices paid.

Under the original proposal, sponsors would have been required to disclose to investors the material assumptions and methodology used in determining the aggregate amount of ABS interests issued by the issuing entity, including those pertaining to any estimated cash flows and the discount rate used. One commenter did not support requiring this disclosure and believed that such disclosure would be irrelevant in CMBS transactions in that the principal balance of the certificates sold to investors would equal the aggregate initial principal balance of the mortgage loans, and CMBS transactions did not utilize overcollateralization (as is the case with covered bonds and other structures).

Under the original proposal, the sponsor would have been required to disclose the representations and warranties concerning the assets, a schedule of exceptions to these representations and warranties, and what factors were used to make the determination that such exceptions should be included in the pool even though they did not meet the representations and warranties.

One commenter agreed that loan-by-loan exceptions should be disclosed but did not comment on whether the disclosure of subjective factors disclosure should be required. This commenter also advocated for a standardized format of disclosure of representations and warranties. Another commenter noted that in recent CMBS transactions, all representations and warranties and all exceptions thereto are fully disclosed. Two commenters were unsupportive of requiring disclosure of why exceptions were allowed into the pool because they stated that such determinations are often qualitative and the benefit of such disclosure would be outweighed by the burden imposed on the issuer. The original proposal also requested comment on whether the rule should require that a blackline of the representations and warranties for the securitization transaction against an industry-accepted standard for model representations and warranties be provided to investors at a reasonable time prior to sale. One commenter noted that it was unnecessary to require that investors be provided with a blackline

so long as the representations and warranties are themselves disclosed.

The original proposal requested comment on whether the rule should specify the particular types of information about a third-party purchaser that should be disclosed, rather than requiring disclosure of any other information regarding the third-party purchaser that is material to investors in light of the circumstances of the particular securitization transaction. One investor commenter generally supported requiring disclosure of any other information regarding the purchaser that is material to investors in light of the circumstances. A few commenters were unsupportive of this disclosure requirement. One commenter stated that there should be a safe harbor for the types of information about the third-party purchaser and that requiring this material information disclosure is too broad. Another commenter stated that disclosure of "material information" is already required under existing disclosure rules.

The agencies are proposing disclosure requirements for the CMBS option substantially consistent with the original proposal. The agencies have carefully considered the concerns raised by commenters, but believe that the importance of the proposed disclosures to investors with respect to third-party purchasers, the retained residual interest (including the purchase price), the material terms of the eligible horizontal residual interest retained by each third-party purchaser (including 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), and the representations and warranties concerning the securitized assets, outweigh any issues associated with the sponsor or third-party purchaser to making such information available.

The agencies are also proposing again to require disclosure of the material terms of the applicable transaction documents with respect to the Operating Advisor, including without limitation, the name and form of organization of the Operating Advisor, the qualification standards applicable to the Operating Advisor and how the Operating Advisor satisfies these standards, and the terms of the Operating Advisor's compensation.

#### d. Transfer of B-Piece

As discussed above, consistent with the original proposal, the proposed rule would allow a sponsor of a CMBS transaction to meet its risk retention requirement where a third-party

purchaser acquires the B-piece, and all other criteria and conditions of the proposed requirements for this option as described are met.

Under the original proposal, the sponsor or, if an eligible third-party purchaser purchased the B-piece, the third-party purchaser, would have been required to retain the required eligible horizontal residual interest for the full duration of the securitization transaction. Numerous commenters urged that this proposal be changed to allow transfer of the B-piece prior to the end of the securitization transaction. Some of the commenters making this recommendation requested a specified termination point (or "sunset") for the CMBS risk retention requirement. Other commenters recommended that third-party purchasers be permitted to transfer the retained interest to other third-party purchasers, either immediately or after a maximum waiting period of one year. Some commenters proposed that there be both an overall sunset period for any risk retention requirement and that, prior to the end of that period, transfers between qualified third-party purchasers be permitted.

Several commenters asserted that permitting transfers by third-party purchasers was critical to the continuation of the third-party purchaser structure for CMBS transactions. Another commenter, a securitization sponsor, stated that the transfer restrictions included in the original proposal would undermine the effectiveness of the CMBS option because some investors could not (due to fiduciary or contractual obligations) or did not desire to invest where such restrictions would be imposed. A broker-dealer commenter stated that it was crucial for the rules to give third-party purchasers some ability to sell the B-piece to qualified transferees because third-party purchasers or their investors would not be able to agree to a prohibition on the sale of the B-piece investment for the entire life of the transaction.

Commenters that advocated a sunset for CMBS risk retention generally requested that it occur after two-to-five years. Commenters that requested permitted transfers to a qualified third-party purchaser by the original B-piece holder prior to the end of the risk retention requirement advocated that there be no minimum retention period by the original B-piece holder, while one commenter suggested a one-year initial retention period.

Certain commenters contended that the restrictions of the original proposal were not necessary to promote good

underwriting and that permitting transfer of the B-piece prior to the end of the securitization transaction would be warranted because after a certain amount of time, performance of the underlying commercial mortgages is dependent more on economic conditions rather than an underwriting requirement. One industry group stated that three years would be sufficient to provide all securitization participants the opportunity to determine the quality of underwriting, arguing that after a three-year period, deficient underwriting or other performance factors would be reflected in the sale price of the retained interest.

Some of the commenters that recommended permitting transfers to qualified third-party purchasers suggested additional conditions, such as that the third-party purchaser also be a qualified institutional buyer or accredited investor for purposes of the Securities Act of 1933, or that the transferee certify that it had performed the same due diligence and had the same access to information as the original third-party purchaser. One commenter suggested that qualified institutional buyer or accredited investor status alone should cause an entity to qualify as a qualified transferee of a third-party purchaser.

The agencies have considered the points raised by commenters on the original proposal with respect to transferability of the B-piece and believe, for the reasons discussed further below, that limited transfers prior to the end of the securitization transaction are warranted. The agencies are therefore proposing, as an exception to the transfer and hedging restrictions of the proposed rule and section 15G of the Exchange Act, to permit the transfer of the retained interest by any initial third-party purchaser to another third-party purchaser at any time after five years after the date of the closing of the securitization transaction, provided that the transferee satisfies each of the conditions applicable to the initial third-party purchaser under the CMBS option (as described above) in connection with such purchase. The proposed rule also would permit transfers by any such subsequent third-party purchaser to any other purchaser satisfying the criteria applicable to initial third-party purchasers. In addition, in the event that the sponsor retained the B-piece at closing, the proposed rule would permit the sponsor to transfer such interest to a purchaser satisfying the criteria applicable to third-party purchasers after a five-year period following the closing of the securitization transaction has expired.

The proposed rule would require that any transferring third-party purchaser provide the sponsor with complete identifying information as to the transferee third-party purchaser.

In considering the comments and formulating the revised proposed rule, the agencies attempted to balance two overriding goals: (1) Not disrupting the existing CMBS third-party purchaser structure, and (2) ensuring that risk retention promotes good underwriting. The agencies followed the analysis of the commenters who asserted that, after a five year period, the quality of the underwriting would be sufficiently evident that the initial third-party purchaser or, if there was no initial third-party purchaser, the sponsor would suffer the consequences of poor underwriting in the form of a reduced sales price for such interest. The agencies also believe that the initial holder of the B-piece, whether a third-party purchaser or the sponsor, would need to assume that retention for a five-year period would result in such holder bearing the consequences of poor underwriting and, thus, that by permitting transfer after the five year period the agencies would not be creating a structure which resulted in the initial holder being less demanding of the underwriting than if it was required to retain the B-piece until the full sunset period applicable to CMBS securitizations had expired. In connection with this, the requirement (among other conditions) that a subsequent purchaser, like the initial third-party purchaser, conduct an independent review of the credit risk of each securitized asset was important to the agencies, as this requirement would emphasize to the initial B-piece holder that the performance of the securitized assets would be scrutinized by any potential purchaser, thus exposing the initial purchaser to the full risks of poor underwriting.

The standards for the Federal banking agencies to provide exemptions to the risk requirements and prohibition on hedging are outlined in section 941(e) of the Dodd-Frank Act. The exemption described above would allow third-party purchasers and sponsors to transfer a horizontal risk retention interest after a five year period to sponsors or third-party purchasers that meet the same standards. The agencies believe that under 15 U.S.C. 78o-11(e)(2), a five-year retention duration helps ensure high underwriting standards for the securitizers and originators of assets that are securitized or available for securitization by forcing sponsors or initial third-party purchasers to absorb a significant

portion of losses related to underwriting deficiencies. Furthermore, the agencies believe that this exemption would meet the statute's requirement that the exemption encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of consumers and businesses to credit on reasonable terms, or otherwise is in the public interest and for the protection of investors. By limiting the risk retention requirement for CMBS to five years rather than the entire duration of the underlying assets, the agencies are responding to commenters' concerns that lifetime retention requirements would eliminate B-piece buyers' ability to participate in the CMBS market, and without their participation, market liquidity for commercial mortgages would be severely impacted. The proposed approach of requiring the third-party purchaser to hold for at least five years accommodates continuing participation of B-piece buyers in the market, in a way that still requires meaningful risk retention as an incentive to good risk management practices by securitizers in selecting assets, and addressing specific concerns about maintaining consumers' and businesses' access to commercial mortgage credit.

The agencies have not adopted the recommendations made by several commenters that transfers to qualified third-party purchasers be permitted with no minimum holding period or after a one year holding period. The agencies decided that unless there was a holding period that was sufficiently long to enable underwriting defects to manifest themselves, the original third-party purchaser might not be incentivized to insist on effective underwriting of the securitized assets. This, in turn, would be in violation of section 941(e)'s requirement that any exemption continue to help ensure high quality underwriting standards. The agencies are therefore proposing a period of five years based on the more conservative comments received as to duration of the CMBS retention period. The agencies believe that permitting transfers to qualifying third-party purchasers after five years should not diminish in any respect the pressure on the sponsor to use proper underwriting methods.

#### Request for Comment

46. Should the period for B-piece transfer be any longer or shorter than five years? Please provide any relevant data analysis to support your conclusion.

47(a). Should the agencies only allow one third-party purchaser to satisfy the risk retention requirement? 47(b).

Should the agencies consider allowing for more than two third-party purchasers to satisfy the risk retention requirement?

48(a). Are the third-party qualifying criteria the agencies are proposing appropriate? 48(b). Why or why not? 48(c). Would a sponsor be able to track the source of funding for other purposes to determine if funds are used for the purchase of the B-piece?

49(a). Are the Operating Advisor criteria and responsibilities the agencies are proposing appropriate? 49(b). Why or why not?

#### e. Duty To Comply

The original proposal would have required the sponsor of a CMBS transaction to maintain and adhere to policies and procedures to monitor the third-party purchaser's compliance with the CMBS option and to notify investors if the sponsor learns that the third-party purchaser no longer complies with such requirements.

Several commenters criticized the proposed monitoring obligations because they believed that such monitoring would not be feasible for a sponsor, especially the restriction on hedging. Some commenters proposed alternatives, such as making the Operating Advisor responsible for compliance by the third-party purchaser or using contractual representations and warranties and covenants to ensure compliance.

Another commenter suggested that the pooling and servicing agreement or similar transaction document set forth a dispute resolution mechanism for investors, including the ability of investors to demand an investigation of possible noncompliance by the special servicer upon request from a specified percentage of ABS and how the costs of resulting investigations would be borne and that independent parties would perform such investigations.

The agencies have considered these comments but continue to believe that it is important for the sponsor to monitor third-party purchasers. A transfer of risk to a third-party purchaser is not, under the agencies' view of the risk retention requirement, a transfer of the sponsor's general obligation to satisfy the requirement. Although the proposal allows third-party purchasers to retain the required eligible horizontal residual interest, the agencies believe that the sponsor of the CMBS transaction should ultimately be responsible for compliance with the requirements of the CMBS option, rather

than shifting the obligation to the third-party purchaser or Operating Advisor, as some commenters on the original proposal suggested, by requiring certifications or representations and warranties. Additionally, the agencies are not proposing a specific requirement that the pooling and servicing agreement or similar transaction document include dispute resolution provisions because the agencies believe that most investor disputes, particularly disputes related to possible noncompliance by the special servicer, will be resolved through the proposed Operating Advisor process. However, this is not intended to limit investors and other transaction parties from continuing to include negotiated rights and remedies in CMBS transaction documents, including dispute resolution provisions in addition to the proposed Operating Advisor provisions.

Accordingly, the agencies are proposing the same monitoring and notification requirements as under the original proposal with no modifications. The sponsor would be required to maintain policies and procedures to actively monitor the third-party purchaser's compliance with the requirements of the rule and to notify (or cause to be notified) ABS holders in the event of any noncompliance with the rule.

#### 6. Government-Sponsored Enterprises

##### a. Overview of Original Proposal and Public Comment

In the original proposal, the agencies proposed that the guarantee (for timely payment of principal and interest) by the Enterprises while they operate under the conservatorship or receivership of FHFA with capital support from the United States would satisfy the risk retention requirements of section 15G of the Exchange Act with respect to the mortgage-backed securities issued by the Enterprises. Similarly, an equivalent guarantee provided by a limited-life regulated entity that has succeeded to the charter of an Enterprise, and that is operating under the authority and oversight of FHFA under section 1367(i) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, would satisfy the risk retention requirements, provided that the entity is operating with capital support from the United States. The original proposal also provided that the hedging and finance provisions would not apply to an Enterprise while operating under conservatorship or receivership with capital support from the United States, or to a limited-life regulated entity that

has succeeded to the charter of an Enterprise and is operating under the authority and oversight of FHFA with capital support from the United States. Under the original proposal, a sponsor (that is, the Enterprises) utilizing this option would have been required to provide to investors, in written form under the caption "Credit Risk Retention" and, upon request, to FHFA and the Commission, a description of the manner in which it met the credit risk retention requirements.

As the agencies explained in the original proposal, if either an Enterprise or a successor limited-life regulated entity began to operate other than as described, the Enterprise or successor entity would no longer be able to avail itself of the credit risk retention option provided to the Enterprises and would have become subject to the related requirements and prohibitions set forth elsewhere in the proposal.

In the original proposal, the agencies explained what factors they took into account regarding the treatment of the Enterprises while they were in conservatorship or receivership with capital support from the United States.<sup>75</sup> First, the agencies observed that because the Enterprise fully guaranteed the timely payment of principal and interest on the mortgage-backed securities they issued, the Enterprises were exposed to the entire credit risk of the mortgages that collateralize those securities. The agencies also highlighted that the Enterprises had been operating under the conservatorship of FHFA since September 6, 2008, and that as conservator, FHFA had assumed all powers formerly held by each Enterprise's officers, directors, and shareholders and was directing its efforts as conservator toward minimizing losses, limiting risk exposure, and ensuring that the Enterprises priced their services to adequately address their costs and risk. Finally, the agencies described how each Enterprise, concurrent with being placed in conservatorship, entered into a Senior Preferred Stock Purchase Agreement (PSPA) with the United States Department of the Treasury (Treasury) and that the PSPAs provided capital support to the relevant Enterprise if the Enterprise's liabilities had exceeded its assets under GAAP.<sup>76</sup>

<sup>75</sup> See Original Proposal, 76 FR at 24111–24112.

<sup>76</sup> Under each PSPA as amended, Treasury purchased senior preferred stock of each Enterprise. In exchange for this cash contribution, the liquidation preference of the senior preferred stock that Treasury purchased from the Enterprise under the respective PSPA increases in an equivalent amount. The senior preferred stock of each Enterprise purchased by Treasury is senior to all

The agencies received a number of comments on the original proposal with respect to the Enterprises, including comments from banks and other financial businesses, trade organizations, public interest and public policy groups, members of Congress and individuals. A majority of the commenters supported allowing the Enterprises' guarantee to be an acceptable form of risk retention in accordance with the original proposal.

Many of the comments that supported the original proposal noted that the capital support by the United States government, coupled with the Enterprises' guarantee, equated to 100 percent risk retention by the Enterprises. Others believed the treatment of the Enterprises in the original proposal was important to support the mortgage market and to ensure adequate credit in the mortgage markets, especially for low down payment loans. One commenter representing community banks stated that, without the provision for the Enterprises in the original proposal, many community banks would have difficulty allocating capital to support risk retention and, by extension, continued mortgage activity. A few commenters specifically supported the original proposal's exception for the Enterprises from the prohibitions on hedging. These commenters asserted that preventing the Enterprise from hedging would be unduly burdensome, taking into consideration the 100 percent guarantee of the Enterprises, while other sponsors would only be required to meet a 5 percent risk retention requirement. At least one commenter noted that applying the hedging prohibition to the Enterprises could have negative consequences for taxpayers, given the capital support from the United States.

A number of the commenters said that, even though they supported the original proposal, they believed that it could create an advantage for the

other preferred stock, common stock or other capital stock issued by the Enterprise.

Treasury's commitment to each Enterprise is the greater of: (1) \$200 billion; or (2) \$200 billion plus the cumulative amount of the Enterprise's net worth deficit as of the end of any calendar quarter in 2010, 2011 and 2012, less any positive net worth as of December 31, 2012. Under amendments to each PSPA signed in August 2012, the fixed-rate quarterly dividend that each Enterprise had been required to pay to Treasury was replaced, beginning on January 1, 2013, with a variable dividend based on each Enterprise's net worth, helping to ensure the continued adequacy of the financial commitment made under the PSPA and eliminating the need for an Enterprise to borrow additional amounts to pay quarterly dividends to Treasury. The PSPAs also require the Enterprises to reduce their retained mortgage portfolios over time.

Enterprises over private lenders. These commenters recommended that the agencies adopt a broader definition for QRM to address any potential disadvantages for private lenders, rather than change the risk retention option proposed for the Enterprises.<sup>77</sup>

Those commenters that opposed the treatment of the Enterprises in the original proposal generally believed that it would provide the Enterprises with an unfair advantage over private capital, and asserted that it would be inconsistent with the intent of section 15G of the Exchange Act. Many of these commenters stated that this aspect of the original proposal, if adopted, would prevent private capital from returning to the mortgage markets and would otherwise make it difficult to institute reform of the Enterprises. One commenter believed the original proposal interfered with free market competition and placed U.S. government proprietary interests ahead of the broader economic interests of the American people. Other comments suggested that the original proposal's treatment of the Enterprises could have negative consequences for taxpayers.

#### b. Proposed Treatment

The agencies have carefully considered the comments received with respect to the original proposal's provision for the Enterprises. While the agencies understand the issues involved with the Enterprises' participation in the mortgage market, the agencies continue to believe that it is appropriate, from a public policy perspective, to recognize the guarantee of the Enterprises as fulfilling their risk retention requirement under section 15G of the Exchange Act, while in conservatorship or receivership with the capital support of the United States. The authority and oversight of the FHFA over the operations of the Enterprises or any successor limited-life regulated entity during a conservatorship or receivership,<sup>78</sup> the full guarantee provided by these entities on the timely payment of principal and interest on the mortgage-backed securities that they issue, and the capital support provided

<sup>77</sup> The comments that relate to the QRM definition are addressed in Part VI of this Supplementary Information, which discusses the proposed QRM definition.

<sup>78</sup> In this regard, FHFA is engaged in several initiatives to contract the Enterprises presence in the mortgage markets, including increasing and changing the structure of the guarantee fees charged by the Enterprises and requiring the Enterprises to develop risk-sharing transactions to transfer credit risk to the private sector. See, e.g., FHFA 2012 Annual Report to Congress, at 7–11 (June 2013), available at <http://www.FHFA.gov> (FHFA 2012 Report).

by Treasury under the PSPAs<sup>79</sup> provide a reasonable basis consistent with the goals and intent of section 15G for recognizing the Enterprise guarantee as meeting the Enterprises' risk retention requirement.

Accordingly, the agencies are now proposing the same treatment for the Enterprises as under the original proposal, without modification. Consistent with the original proposal, if any of the conditions in the proposed rule cease to apply, the Enterprises or any successor organization would no longer be able to rely on its guarantee to meet the risk retention requirement under section 15G of the Exchange Act and would need to retain risk in accordance with one of the other applicable sections of this risk retention proposal.

For similar reasons, the restrictions and prohibitions on hedging and transfers of retained interests in the proposal (like the original proposal) would not apply to the Enterprises or any successor limited-life regulated entities, as long as the Enterprise (or, as applicable, successor entity) is operating consistent with the conditions set out in the rule. In the past, the Enterprises have sometimes acquired pool insurance to cover a percentage of losses on the mortgage loans comprising the pool.<sup>80</sup> FHFA also has made risk-sharing through a variety of alternative mechanisms to be a major goal of its Strategic Plan for the Enterprise Conservatorships.<sup>81</sup> Because the proposed rule would require each Enterprise, while in conservatorship or receivership, to hold 100 percent of the credit risk on mortgage-backed securities that it issues, the prohibition on hedging in the proposal related to the credit risk that the retaining sponsor is required to retain would limit the ability of the Enterprises to require such pool insurance in the future or take other reasonable actions to limit losses that would otherwise arise from the Enterprises' 100 percent exposure to the credit risk of the securities that they issue. Because the proposal would apply only so long as the relevant Enterprise operates under the authority and control of PHFA and with capital support from the United States, the agencies continue to believe that the proposed treatment of the Enterprises as

meeting the risk retention requirement of section 15G of the Exchange Act should be consistent with the maintenance of quality underwriting standards, in the public interest, and consistent with the protection of investors.<sup>82</sup>

As explained in the original proposal and noted above, the agencies recognize both the need for, and importance of, reform of the Enterprises, and expect to revisit and, if appropriate, modify the proposed rule after the future of the Enterprises and of the statutory and regulatory framework for the Enterprises becomes clearer.

## 7. Open Market Collateralized Loan Obligations

### a. Overview of Original Proposal and Public Comment

In the original proposal, the agencies observed that, in the context of CLOs, the CLO manager generally acts as the sponsor by selecting the commercial loans to be purchased by the CLO issuing entity (the special purpose vehicle that holds the CLO's collateral assets and issues the CLO's securities) and then manages the securitized assets once deposited in the CLO structure.<sup>83</sup> Accordingly, the original proposal required the CLO manager to satisfy the minimum risk retention requirement for each CLO securitization transaction that it manages. The original proposal did not include a form of risk retention designed specifically for CLO securitizations. Accordingly, CLO managers generally would have been required to satisfy the minimum risk retention requirement by holding a sufficient amount of standard risk retention in horizontal, vertical, or L-shaped form.

Many commenters, including several participants in CLOs, raised concerns regarding the impact of the proposal on certain types of CLO securitizations, particularly CLOs that are securitizations of commercial loans originated and syndicated by third parties and selected for purchase on the open market by asset managers unaffiliated with the originators of the loans (open market CLOs). Some commenters asserted that most asset management firms currently serving as open market CLO managers do not have the balance sheet capacity to fund 5 percent horizontal or vertical slices of the CLO. Thus, they argued, imposing standard risk retention requirements on these managers could cause independent CLO managers to exit the market or be acquired by larger firms,

thereby limiting the number of participants in the market and raising barriers to entry. According to these commenters, the resulting erosion in market competition could increase the cost of credit for large, non-investment grade companies represented in CLO portfolios above the level that would be consistent with the credit quality of these companies.

Certain commenters also asserted that open market CLO managers are not "securitizers" under section 15G of the Exchange Act. These commenters argued that because the CLO managers themselves would never legally own, sell, or transfer the loans that comprised the CLO's collateral pool, but only direct which assets would be purchased by the CLO issuing entity, they should not be "securitizers" as defined in section 15G. Thus, these commenters argued that the agencies' proposal to impose a sponsor's risk retention requirement on open market CLO managers is contrary to the statute.<sup>84</sup>

One commenter argued that CLO underwriters (typically investment banks) are "securitizers" for risk retention purposes and agent banks of the underlying loans are "originators." This commenter noted that the CLO underwriter typically finances the accumulation of most of the initial loan assets until the CLO securities are issued. According to this commenter, the CLO manager selects the loans, but the CLO underwriter legally transfers them and takes the market value risk of the accumulating loan portfolio should the CLO transaction fail to close. However, other commenters argued that no party within the open market CLO structure constitutes a "securitizer" under section 15G. These commenters stated that they did not view the underwriter as a "securitizer" because it does not select or manage the loans securitized in a CLO transaction or transfer them to the issuer. These commenters requested that the agencies establish an exemption from the risk retention requirement for certain open market CLOs.

In addition to the above comments, a commenter proposed that subordinated collateral management fees and incentive fees tied to the internal rate of return received by investors in the CLO's equity tranche be counted towards the CLO manager's risk retention requirement, as receipt of these fees is contingent upon the satisfactory performance of the CLO and

<sup>79</sup> By its terms, a PSPA with an Enterprise may not be assigned, transferred, inure to the benefit of, any limited-life, regulated entity established with respect to the Enterprise without the prior written consent of Treasury.

<sup>80</sup> Typically, insurers would pay the first losses on a pool of loans, up to 1 or 2 percent of the aggregate unpaid principal balance of the pool.

<sup>81</sup> See, e.g., FHFA 2012 Report at 7–11.

<sup>82</sup> See Original Proposal, 76 FR at 24112.

<sup>83</sup> See *id.* at 24098 n. 42.

<sup>84</sup> See Part II.A.2 of this Supplementary Information for a discussion of the definition of "securitizer" under section 15G of the Exchange Act.

timely payment of interest to CLO bondholders, thereby aligning the interest of CLO managers and investors.

#### b. Proposed Requirement

The agencies have considered the concerns raised by commenters with respect to the original proposal and CLOs. As explained in the original proposal, the agencies believe that the CLO manager is a “securitizer” under section 15G of the Exchange Act because it selects the commercial loans to be purchased by the CLO issuing entity for inclusion in the CLO collateral pool, and then manages the securitized assets once deposited in the CLO structure. The agencies believe this is consistent with part (B) of the definition of securitizer which includes “a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.”<sup>85</sup> The CLO manager typically organizes and initiates the transaction as it has control over the formation of the CLO collateral pool, the essential aspect of the securitization transaction. It also indirectly transfers the underlying assets to the CLO issuing entity typically by selecting the assets and directing the CLO issuing entity to purchase and sell those assets.

The agencies believe that reading the definition of “securitizer” to include a typical CLO manager or other collateral asset manager that performs such functions is consistent with the purposes of the statute and principles of statutory interpretation. The agencies believe that the text itself supports the interpretation that a CLO manager is a securitizer because, as explained above, the agencies believe that the CLO manager organizes and initiates a securitization transaction by indirectly transferring assets to the issuing entity. However, in the case that any ambiguity exists regarding the statutory meaning of “transfer” and whether or not it means a legal sale or purchase, the agencies may look to the rest of the statute, including the context, when interpreting its meaning. Furthermore, as stated by the Supreme Court, “a statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant.”<sup>86</sup>

It is clear from the statutory text and legislative history of section 15G of the Exchange Act that Congress intended for risk retention to be held by collateral

asset managers (such as CLO or CDO managers), who are the parties who determine the credit risk profile of securitized assets in many types of securitization transactions and therefore should be subject to a regulatory incentive to monitor the quality of the assets they cause to be transferred to an issuing entity.<sup>87</sup> Additionally, the agencies believe a narrow reading could enable market participants to evade the operation of the statute by employing an agent to select assets to be purchased and securitized. This could potentially render section 15G of the Exchange Act practically inoperative for any transaction where this structuring could be achieved, and would have an adverse impact on competition and efficiency by permitting market participants to do indirectly what they are prohibited from doing directly.

The agencies also recognize that the standard forms of risk retention in the original proposal could, if applied to open market CLO managers, result in fewer CLO issuances and less competition in this sector. The agencies therefore have developed a revised proposal that is designed to allow meaningful risk retention to be held by a party that has significant control over the underwriting of assets that are typically securitized in CLOs, without causing significant disruption to the CLO market. The agencies’ goal in proposing this alternative risk retention option is to avoid having the general risk retention requirements create unnecessary barriers to potential open market CLO managers sponsoring CLO securitizations. The agencies believe that this alternate risk retention option could benefit commercial borrowers by making additional credit available in the syndicated loan market.

Under the proposal, an open market CLO would be defined as a CLO whose assets consist of senior, secured syndicated loans acquired by such CLO directly from sellers in open market transactions and servicing assets, and 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. Accordingly, this definition would not include CLOs (often referred to as “balance sheet” CLOs) where the CLO obtains a majority of its assets from entities that control or influence its portfolio selection. Sponsors of balance sheet CLOs, would be subject to the standard risk retention options in the proposed rule because the particular considerations for risk

retention relevant to an open market CLO (as discussed above) should not affect sponsors of balance sheet CLOs in the same manner. Furthermore, as commenters on the original proposal indicated, sponsors of balance sheet CLOs should be able to obtain sufficient support to meet any risk retention requirement from the affiliate that is the originator of the securitized loans in a balance sheet CLO.

Under the proposal, in addition to the standard options for vertical or horizontal risk retention, an open market CLO could satisfy the risk retention requirement if the firm serving as lead arranger for each loan purchased by the CLO were to retain at the origination of the syndicated loan at least 5 percent of the face amount of the term loan tranche purchased by the CLO. The lead arranger would be required to retain this portion of the loan tranche until the repayment, maturity, involuntary and unscheduled acceleration, payment default, or bankruptcy default of the loan. This requirement would apply regardless of whether the loan tranche was purchased on the primary or secondary market, or was held at any particular time by an open market CLO issuing entity.

The sponsor of an open market CLO could presumably negotiate that the lead arranger of each loan tranche purchased for the CLO portfolio retain a portion of the relevant loan tranche at origination. However, the sponsors of open market CLOs have frequently arranged for the purchase of loans in the secondary market as well as from originators. For purchases on the secondary market, negotiation of risk retention in connection with such purchases would likely be impractical. Accordingly, the proposal contemplates that specific senior, secured term loan tranches within a broader syndicated credit facility would be designated as “CLO-eligible” at the time of origination if the lead arranger committed to retain 5 percent of each such CLO-eligible tranche, beginning on the closing date of the syndicated credit facility.

A CLO-eligible tranche could be identical in its terms to a tranche not so designated, and could be sized based on anticipated demand by open market CLOs. For the life of the facility, loans that are part of the CLO-eligible tranche could then trade in the secondary market among both open market CLOs and other investors. The agencies acknowledge that this approach may result in the retention by loan originators of risk associated with assets that are no longer held in securitizations, but have narrowly

<sup>85</sup> See 15 U.S.C. 78o-11(a)(3)(B).

<sup>86</sup> See, e.g. *Corley v. United States*, 556 U.S. 303, 129 S.Ct 1558, 1566, 173 L.Ed.2d 443 (2009).

<sup>87</sup> S. Rep. No. 111-176 (April 30, 2010).

tailored this option to eliminate that result as much as possible.

In order to ensure that a lead arranger retaining risk had a meaningful level of influence on loan underwriting terms, the lead arranger would be required to have taken an initial allocation of at least 20 percent of the face amount of the broader syndicated credit facility, with no other member of the syndicate assuming a larger allocation or commitment. Additionally, a retaining lead arranger would be required to comply with the same sales and hedging restrictions as sponsors of other securitizations until the repayment, maturity, involuntary and unscheduled acceleration, payment default, or bankruptcy default of the loan tranche.

Under the proposal, a lead arranger retaining a "CLO-eligible" loan tranche must be identified at the time of the syndication of the broader credit facility, and legal documents governing the origination of the syndicated credit facility must include covenants by the lead arranger with respect to satisfaction of requirements described above.

Voting rights within the broader syndicated credit facility must also be defined in such a way that holders of the "CLO-eligible" loan tranche had, at a minimum, consent rights with respect to any waivers and amendments of the legal documents governing the underlying CLO-eligible loan tranche that can adversely affect the fundamental terms of that tranche. This is intended to prevent the possible erosion of the economic terms, maturity, priority of payment, security, voting provisions or other terms affecting the desirability of the CLO-eligible loan tranche by subsequent modifications to loan documents. Additionally, the pro rata provisions, voting provisions and security associated with the CLO-eligible loan tranche could not be materially less advantageous to the holders of that tranche than the terms of other tranches of comparable seniority in the broader syndicated credit facility.

Under the proposal, the sponsor of an open market CLO could avail itself of the option for open market CLOs only if: (1) The CLO does not hold or acquire any assets other than CLO-eligible loan tranches (discussed above) and servicing assets (as defined in the proposed rule); (2) the CLO does not invest in ABS interests or credit derivatives (other than permitted hedges of interest rate or currency risk); and (3) all purchases of assets by the CLO issuing entity (directly or through a warehouse facility used to accumulate the loans prior to the issuance of the CLO's liabilities) are made in open market transactions. The governing

documents of the open market CLO would require, at all times, that the assets of the open market CLO consist only of CLO-eligible loan tranches and servicing assets.

The proposed option for open market CLOs is intended to allocate risk retention to the parties that originate the underlying loans and that likely exert the greatest influence on how the loans are underwritten, which is an integral component of ensuring the quality of assets that are securitized. In developing the proposed risk retention option for open market CLOs, the agencies have considered the factors set forth in section 15G(d)(2) of the Exchange Act.<sup>88</sup> Section 15G permits the agencies to allow an originator (rather than a sponsor) to retain the required amount of credit risk and to reduce the amount of credit risk required of the sponsor by the amount retained by the originator.<sup>89</sup>

The terms of the proposed option for eligible open market CLOs include conditions designed to provide incentive to lead arrangers to monitor the underwriting of loans they syndicate that may be sold to an eligible open market CLO by requiring that lead arrangers retain risk on these leveraged loans that could be securitized through CLOs. The agencies believe that this proposed risk retention option for open market CLOs would meaningfully align the incentives of the party most involved with the credit quality of these loans—the lead arranger—with the interests of investors. Alternatively, incentive would be placed on the CLO manager to monitor the credit quality of loans it securitizes if it retains risk under the standard risk retention option.

In response to commenter requests that the agencies recognize incentive fees as risk retention, the agencies recognize that management fees incorporate credit risk sensitivity and contribute to aligning the interests of the CLO manager and investors with respect to the quality of the securitized loans. However, these fees do not appear to provide an adequate substitute for risk retention because they typically have

<sup>88</sup> 15 U.S.C. 78o–11(d)(2). These factors are whether the assets sold to the securitizer have terms, conditions, and characteristics that reflect low credit risk; whether the form or volume of transactions in securitization markets creates incentives for imprudent origination of the type of loan or asset to be sold to the securitizer; and the potential impact of risk retention obligations on the access of consumers and business to credit on reasonable terms, which may not include the transfer of credit risk to a third party.

<sup>89</sup> See *id.* at Section 78o–11(c)(G)(iv) and (d) (permitting the Commission and Federal banking agencies to allow the allocation of risk retention from a sponsor to an originator).

small expected value (estimated as equivalent to a horizontal tranche of less than 1 percent), especially given that CLOs securitize leveraged loans, which carry higher risk than many other securitized assets. Additionally, these fees are not funded in cash at closing and therefore may not be available to absorb losses as expected. Generally, the agencies have declined to recognize unfunded forms of risk retention for purposes of the proposal (such as fees or guarantees), except in the case of the Enterprises under the conditions specified with regard to their guarantees.

Under the option for open market CLOs, the sponsor relying on the option would be required to provide, or cause to be provided, certain disclosures to potential investors. The sponsor would be required to disclose this information a reasonable period of time prior to the sale of the asset-backed securities in the securitization transaction (and at least annually with respect to information regarding the assets held by the CLO) and, upon request, to the Commission and its appropriate Federal banking agency, if any. First, a sponsor relying on the CLO option would need to disclose a complete list of every asset held by an open market CLO (or before the CLO's closing, in a warehouse facility in anticipation of transfer into the CLO at closing). This list would need to include the following information (i) the full legal name and Standard Industrial Classification category code of the obligor of the loan or asset; (ii) the full name of the specific loan tranche held by the CLO; (iii) the face amount of the loan tranche held by the CLO; (iv) the price at which the loan tranche was acquired by the CLO; and (v) for each loan tranche, the full legal name of the lead arranger subject to the sales and hedging restrictions of § \_\_.12 of the proposed rule. Second, the sponsor would need to disclose the full legal name and form of organization of the CLO manager.

#### Request for Comment

50(a). Does the proposed CLO risk retention option present a reasonable allocation of risk retention among the parties that originate, purchase, and sell assets in a CLO securitization? 50(b). Are there any changes that should be made in order to better align the interests of CLO sponsors and CLO investors?

51. Are there technical changes to the proposed CLO option that would be needed or desirable in order for lead arrangers to be able to retain the risk as proposed, and for CLO sponsors to be able to rely on this option?

52(a). Who should assume responsibility for ensuring that lead arrangers comply with requirement to retain an interest in CLO-eligible tranches? 52(b). Would some sort of ongoing reporting or periodic certification by the lead arranger to holders of the CLO-eligible tranche be feasible? 52(c). Why or why not?

53(a). The agencies would welcome suggestions for alternate or additional criteria for identifying lead arrangers. 53(b). Do loan syndications typically have more than one lead arranger who has significant influence over the underwriting and documentation of the loan? 53(c). If so, should the risk retention requirement be permitted to be shared among more than one lead arranger? 53(d). What practical difficulties would this present, including for the monitoring of compliance with the retention requirement? 53(e). How could the rule assure that each lead arranger's retained interest is significant enough to influence its underwriting of the loan?

54(a). Is the requirement for the lead arranger to take an initial allocation of 20 percent of the broader syndicated credit facility sufficiently large to ensure that the lead arranger can exert a meaningful level of influence on loan underwriting terms? 54(b). Could a smaller required allocation accomplish the same purpose?

55(a). The proposal permits lead arrangers to sell or hedge their retained interest in a CLO-eligible loan tranche if those loans experience a payment or bankruptcy default or are accelerated. Would the knowledge that it could sell or hedge a defaulted loan in those circumstances unduly diminish the lead arranger's incentive to underwrite and structure the loan prudently at origination? 55(b). Should the agencies restrict the ability of lead arrangers to sell or hedge their retained interest under these circumstances? 55(c). Why or why not?

56(a). Should the lead arranger role for "CLO-eligible" loan tranches be limited to federally supervised lending institutions, which are subject to regulatory guidance on leveraged lending? 56(b). Why or why not?

57(a). Should additional qualitative criteria be placed on CLO-eligible loan tranches to ensure that they have lower credit risk relative to the broader leveraged loan market? 57(b). What such criteria would be appropriate?

58(a). Should managers of open market CLOs be required to invest principal in some minimal percentage of the CLO's first loss piece in addition to meeting other requirements for open

market CLOs proposed herein? 58(b). Why or why not?

59(a). Is the requirement that all assets (other than servicing assets) consist of CLO-eligible loan tranches appropriate? 59(b). To what extent could this requirement impede the ability of a CLO sponsor to diversify its assets or its ability to rely on this option? 59(c). Does this requirement present any practical difficulties with reliance on this option, particularly the ability of CLO sponsors to accumulate a sufficient number of assets from CLO-eligible loan tranches to meet this requirement? 59(d). If so, what are they? 59(e). Would it be appropriate for the agencies to provide a transition period (for example, two years) after the effective date of the rule to allow some investment in corporate or other obligations other than CLO-eligible loan tranches or servicing assets while the market adjusts to the new standards? 59(f). What transition would be appropriate? 59(g). Would allowing a relatively high percentage of investment in such other assets in the early years following the effective date (such as 10 percent), followed by a gradual reduction, facilitate the ability of the market to utilize the proposed option? 59(h). Why or why not? 59(i). What other transition arrangements might be appropriate?

60(a). Should an open market CLO be allowed permanently to hold some *de minimis* percentage of its collateral assets in corporate obligations other than CLO-eligible loan tranches under the option? 60(b). If so, how much?

61(a). Is the requirement that permitted hedging transactions be limited to interest rate and currency risks appropriate? 61(b). Are there other derivative transactions that CLO issuing entities engage in to hedge particular risks arising from the loans they hold and not as means of gaining synthetic exposures?

62(a). Is the requirement that the holders of a CLO-eligible loan tranche have consent rights with respect to any material waivers and amendments of the underlying legal documents affecting their tranche appropriate? 62(b). How should waivers and amendments that affect all tranches (such as waivers of defaults or amendments to covenants) be treated for this purpose? 62(c). Should holders of CLO-eligible loan tranches be required to receive special rights with respect those matters, or are their interests sufficiently aligned with other lenders?

63. How would the proposed option facilitate (or not facilitate) the continuance of open market CLO issuances?

64(a). What percentage of currently outstanding CLOs, if any, have securitized assets that consist entirely of syndicated loans? 64(b). What percentage of securitized assets of currently outstanding CLOs consist of syndicated loans?

65(a). Should unfunded portions of revolving credit facilities be allowed in open market CLO collateral portfolios, subject to some limit, as is current market practice? 65(b). If yes, what form should risk retention take? 65(c). Would the retention of 5 percent of an unfunded revolving commitment to lend (plus 5 percent of any outstanding funded amounts) provide the originator with incentives similar to those provided by retention of 5 percent of a funded term loan? 65(d). Why or why not?

66(a). Would a requirement for the CLO manager to retain risk in the form of unfunded notes and equity securities, as proposed by an industry commenter, be a reasonable alternative for the above proposal? 66(b). How would this meet the requirements and purposes of section 15G of the Exchange Act?

## 8. Municipal Bond "Repackaging" Securitizations

Several commenters on the original proposal requested that the agencies exempt municipal bond repackagings securitizations from risk retention requirements, the most common form of which are often referred to as "tender option bonds" (TOBs).<sup>90</sup> These commenters argued that these transactions should be exempt from risk retention for the following reasons:

- Securities issued by municipal entities are exempt, so securitizations involving these securities should also be exempt;
- Municipal bond repackagings are not the type of securitizations that prompted Congress to enact section 15G of the Exchange Act, but rather are

<sup>90</sup> As described by one commenter, a typical TOBs transaction consists of the deposit of a single issue of highly rated, long-term municipal bonds in a trust and the issuance by the trust of two classes of securities: A floating rate, puttable security (the "floaters"), and an inverse floating rate security (the "residual"). No tranching is involved. The holders of floaters have the right, generally on a daily or weekly basis, to put the floaters for purchase at par, which put right is supported by a liquidity facility delivered by a highly rated provider and causes the floaters to be a short-term security. The floaters are in large part purchased and held by money market mutual funds. The residual is held by a longer term investor (bank, insurance company, mutual fund, hedge fund, etc.). The residual investors take all of the market and structural risk related to the TOBs structure, with the floaters investors only taking limited, well-defined insolvency and default risks associated with the underlying municipal bonds, which risks are equivalent to those associated with investing in such municipal bonds directly.

securitizations caught in the net cast by the broad definition of ABS. In fact, the underlying collateral of TOBs has very lower credit risk and is structured to meet the credit quality requirements of Rule 2a-7 under the Investment Company Act of 1940;<sup>91</sup>

- Imposing risk retention in the TOBs market would reduce the liquidity of municipal bonds, which would lead to an increase in borrowing costs for municipalities and other issuers of municipal bonds, as well as a decrease in the short-term investments available for tax-exempt money market funds; and

- TOB programs are financing vehicles that are used because more traditional forms of securities financing are inefficient in the municipal securities market; TOB programs are not intended to, and do not, transfer material investment risk from the securitizer to investors. The securitizer in a TOB program (whether the TOB program sponsor or a third-party investor) has “skin in the game” by virtue of (i) the nature of the TOB inverse floater interest it owns, which represents ownership of the underlying municipal securities and is not analogous to other types of ABS programs, or (ii) its provision of liquidity coverage or credit enhancement, or its obligation to reimburse the provider of liquidity coverage or credit enhancement for any losses.

Another commenter asserted that TOBs and other types of municipal repackaging transactions continue to offer an important financing option for municipal issuers by providing access to a more diverse investor base, a more liquid market and the potential for lower interest rates. According to this commenter, if TOBs were subject to the risk retention requirements of the proposal, the cost of such financing would increase significantly, sponsor banks would likely scale back the issuance of TOBs, and as a result the availability of tax-exempt investments in the market would decrease.

In order to reflect and incorporate the risk retention mechanisms currently implemented by the market, the agencies are proposing to provide two additional risk retention options for certain municipal bond repackagings. The proposed rule closely tracks certain requirements for these repackagings, outlined in IRS Revenue Procedure 2003-84, that are relevant to risk retention.<sup>92</sup> Specifically, the re-proposed rule proposes additional risk

retention options for certain municipal bond repackagings in which:

- Only two classes of securities are issued: A tender option bond and a residual interest;
- The tender option bond qualifies for purchase by money market funds under Rule 2a-7 under the Investment Company Act of 1940;
- The holder of a tender option bond must have the right to tender such bonds to the issuing entity for purchase at any time upon no more than 30 days’ notice;
- The collateral consists solely of servicing assets and municipal securities as defined in Section 3(a)(29) of the Securities Exchange Act of 1934 and all of those securities have the same municipal issuer and the same underlying obligor or source of payment;
- Each of the tender option bond, the residual interest and the underlying municipal security are issued in compliance with the Internal Revenue Code of 1986, as amended (the “IRS Code”), such that the interest payments made on those securities are excludable from the gross income of the owners;
- The issuing entity has a legally binding commitment from a regulated liquidity provider to provide 100 percent guarantee or liquidity coverage with respect to all of the issuing entity’s outstanding tender option bonds;<sup>93</sup> and
- The issuing entity qualifies for monthly closing elections pursuant to IRS Revenue Procedure 2003-84, as amended or supplemented from time to time.

An issuing entity that meets these qualifications would be a Qualified Tender Option Bond Entity.

The sponsor of a Qualified Tender Option Bond Entity may satisfy its risk retention requirements under section 10 of the proposed rule if it retains an interest that upon issuance meets the requirements of an eligible horizontal

<sup>93</sup> The agencies received very few comments with respect to the definition of regulated liquidity provider included in the original proposal with respect to the proposed ABCP option. The proposed rule includes the same definition and defines a regulated liquidity provider as a depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)); a bank holding company (as defined in 12 U.S.C. 1841) or a subsidiary thereof; 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 a foreign bank (or a subsidiary thereof) 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, provided the foreign bank is subject to such standards.

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, as amended or supplemented from time to time, will meet requirements of an eligible vertical interest.<sup>94</sup> The agencies believe that the proposed requirements for both an eligible horizontal residual interest and an eligible vertical interest adequately align the incentives of sponsors and investors.

The sponsor of a Qualified Tender Option Bond Entity may also satisfy its risk retention requirements under this Section if it holds 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 set forth in section 12 of the proposed rule would apply to any municipal securities retained by the sponsor of a Qualified Tender Option Bond Entity in satisfaction of its risk retention requirements under this section.

The sponsor of a Qualified Tender Option Bond Entity could also satisfy its risk retention requirements under subpart B of the proposed rule using any of the other risk retention options in this proposal, provided the sponsor meets the requirements of that option.

#### Request for Comment

67(a). Do each of the additional options proposed with respect to repackagings of municipal securities accommodate existing market practice for issuers and sponsors of tender option bonds? 67(b). If not, are there any technical adjustments that need to be made in order to accommodate existing market practice?

68(a). Do each of the additional options proposed with respect to repackagings of municipal securities adequately align the incentives of sponsors and investors? 68(b). If not, are

<sup>94</sup> Section 4.01(5) of IRS Revenue Procedure 2003-84 defines a tender option termination event as: (1) A bankruptcy filing by or against a tax-exempt bond issuer; (2) 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; (3) a payment default on a tax-exempt bond; (4) 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; (5) a credit rating downgrade below investment grade; (6) the bankruptcy of the issuer and, when applicable, the credit enhancer; or (7) the determination that the municipal securities are taxable.

<sup>91</sup> 17 CFR 270.2a-7.

<sup>92</sup> Revenue Procedure 2003-84, 2003-48 I.R.B. 1159.

there any additional requirements that should be added in order to better align those incentives?

#### 9. Premium Capture Cash Reserve Account

##### a. Overview of Original Proposal and Public Comment

In the original proposal, the agencies were concerned with two different forms of evasive behavior by sponsors to reduce the effectiveness of risk retention. First, in the context of horizontal risk retention, it could have been difficult to measure how much risk a sponsor was retaining where the risk retention requirement was measured using the “par value” of the transaction. In particular, a first loss piece could be structured with a face value of 5 percent, but might have a market value of only cents on the dollar. As the sponsor might not have to put significant amounts of its own funds at risk to acquire the horizontal interest, there was concern that the sponsor could structure around its risk retention requirements and thereby evade a purpose of section 15G.

Second, in many securitization transactions, particularly those involving residential and commercial mortgages, conducted prior to the financial crisis, sponsors sold premium or interest-only tranches in the issuing entity to investors, as well as more traditional obligations that paid both principal and interest received on the underlying assets. By selling premium or interest-only tranches, sponsors could thereby monetize at the inception of a securitization transaction the “excess spread” that was expected to be generated by the securitized assets over time and diminish the value, relative to par value, of the most subordinated credit tranche. By monetizing excess spread before the performance of the securitized assets could be observed and unexpected losses realized, sponsors were able to reduce the impact of any economic interest they may have retained in the outcome of the transaction and in the credit quality of the assets they securitized. This created incentives to maximize securitization scale and complexity, and encouraged unsound underwriting practices.

In order to achieve the goals of risk retention, the original proposal would have increased the required amount of risk retention by the amount of proceeds in excess of 95 percent of the par value of ABS interests, or otherwise required the sponsor to deposit the difference into a first-loss premium capture cash reserve account. The amount placed into the premium capture cash reserve

account would have been separate from and in addition to the sponsor’s base risk retention requirement, and would have been used to cover losses on the underlying assets before such losses were allocated to any other interest or account. As a likely consequence to those proposed requirements, the agencies expected that few, if any, securitizations would require the establishment of a premium capture cash reserve account, as sponsors would simply adjust by holding more risk retention.

The agencies requested comment on the effectiveness and appropriateness of the premium capture cash reserve account and sought input on any alternative methods. Several commenters were supportive of the concept behind the premium capture cash reserve account to prevent sponsors from structuring around the risk retention requirement. However, most commenters generally objected to the premium capture cash reserve account. Many commenters expressed concern that the premium capture cash reserve account would prevent sponsors and originators from recouping the costs of origination and hedging activities, give sponsors an incentive to earn compensation in the form of fees from the borrower instead of cash from deal proceeds, and potentially cause the sponsor to consolidate the entire securitization vehicle for accounting purposes.

Commenters stated that these potential negative effects would ultimately make securitizations uneconomical for many sponsors, and therefore would have a significant adverse impact on the cost and availability of credit. Some commenters also argued that the premium capture cash reserve account exceeded the statutory mandate and legislative intent of the Dodd-Frank Act.

##### b. Proposed Treatment

After careful consideration of all the comments regarding the premium capture cash reserve account, 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 a premium capture cash reserve account provision in the proposed rule. The agencies still consider it important to ensure that there is meaningful risk retention and that sponsors cannot effectively negate or reduce the economic exposure they are required to retain under the proposed rule. However, the proposal to use fair value

to measure the amount of risk retention should meaningfully mitigate the ability of a sponsor to evade the risk retention requirement through the use of deal structures. The agencies also took into consideration the potential negative unintended consequences the premium capture cash reserve account might cause for securitizations and lending markets. The elimination of the premium capture cash reserve account should reduce the potential for the proposed rule to negatively affect the availability and cost of credit to consumers and businesses.

##### Request for Comment

69(a). Should the proposed rule require a sponsor to fund all or part of its risk retention requirement with own funds, instead of using proceeds from the sale of ABS interests to investors?

69(b). Would risk retention be more effective if sponsors had to fund it entirely with their own funds? 69(c). Why or why not?

70(a). Should the agencies require a higher amount of risk retention specifically for transaction structures which rely on premium proceeds, or for assets classes like RMBS and CMBS which have relied historically on the use of premium proceeds? 70(b). If so, how should this additional risk requirement be sized in order to ensure risk retention achieves the right balance of cost versus effectiveness?

#### C. Allocation to the Originator

##### 1. Overview of Original Proposal and Public Comment

As a general matter, the original proposal was structured so that the sponsor of a securitization transaction would be solely responsible for complying with the risk retention requirements established under section 15G of the Exchange Act and the proposed implementing regulations, consistent with that statutory provision. However, subject to a number of considerations, section 15G authorizes the agencies to allow a sponsor to allocate at least a portion of the credit risk it is required to retain to the originator(s) of securitized assets.<sup>95</sup> Accordingly, subject to conditions and restrictions discussed below, the original proposal would have permitted a sponsor to reduce its required risk retention obligations in a securitization transaction by the portion of risk

<sup>95</sup> As discussed above, 15 U.S.C. 78o–11(a)(4) defines the term “originator” as a person who, through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and who sells an asset directly or indirectly to a securitizer (*i.e.*, a sponsor or depositor).

retention obligations assumed by the originators of the securitized assets.

When determining how to allocate the risk retention requirements, the agencies are directed to consider whether the assets sold to the sponsor have terms, conditions, and characteristics that reflect low credit risk; whether the form or volume of the transactions in securitization markets creates incentives for imprudent origination of the type of loan or asset to be sold to the sponsor; and the potential impact of the risk retention obligations on the access of consumers and businesses to credit on reasonable terms, which may not include the transfer of credit risk to a third party.<sup>96</sup>

In the original proposal, the agencies proposed a framework that would have permitted a sponsor of a securitization to allocate a portion of its risk retention obligation to an originator that contributed a significant amount of assets to the underlying asset pool. The agencies endeavored to create appropriate incentives for both the securitization sponsor and the originator(s) to maintain and monitor appropriate underwriting standards without creating undue complexity, which potentially could mislead investors and confound supervisory efforts to monitor compliance. Importantly, the original proposal did not require allocation to an originator. Therefore, it did not raise the types of concerns about credit availability that might arise if certain originators, such as mortgage brokers or small community banks (that may experience difficulty obtaining funding to retain risk positions), were required to fulfill a sponsor's risk retention requirement.

The allocation to originator option in the original proposal was designed to work in tandem with the base vertical or horizontal risk retention options that were set forth in that proposal. The provision would have made the allocation to originator option available to a sponsor that held all of the retained interest under the vertical option or all of the retained interest under the horizontal option, but would not have made the option available to a sponsor that satisfied the risk retention requirement by retaining a combination of vertical and horizontal interests.

Additionally, the original proposal would have permitted a securitization sponsor to allocate a portion of its risk retention obligation to any originator of the underlying assets that contributed at least 20 percent of the underlying assets in the pool. The amount of the retention interest held by each originator that was allocated credit risk in accordance with the proposal was required to be at least 20 percent, but not in excess of the percentage of the securitized assets it originated. The originator would have been required to hold its allocated share of the risk retention obligation in the same manner as would have been required of the sponsor, and subject to the same restrictions on transferring, hedging, and financing the retained interest. Thus, for example, if the sponsor satisfied its risk retention requirements by acquiring an eligible horizontal residual interest, an originator allocated risk would have been required to acquire a portion of that horizontal first-loss interest, in an amount not exceeding the percentage of pool assets created by the originator. The sponsor's risk retention requirements would have been reduced by the amount allocated to the originator. Finally, the original proposal would have made the sponsor responsible for any failure of an originator to abide by the transfer and hedging restrictions included in the proposed rule.

Several commenters opposed the original proposal on allocation to originators in its entirety for a variety of reasons. A common reason stated was that originators would be placed in an unequal bargaining position with sponsors. Other commenters supported the proposed provision, but many urged that it be revised. Several commenters stated that requiring that the originator use the same form of risk retention as the sponsor should be removed, while one commenter proposed that if a sponsor desired to allocate a portion of risk retention to an originator, only the horizontal retention option should be used. Many commenters stated that the proposed 20 percent origination threshold required in order for the option to be used was too high. One commenter urged that an originator that originated more than 50 percent of the securitized assets be required to retain at least 50 percent of the required retention. Another commenter suggested that an originator retaining a portion of the required interest be allocated only a percentage of the loans it originated, rather than an allocation of the entire pool, as proposed. The agencies also received comments that the definition of

“originator” ought to include parties that purchase assets from entities that create the assets and that allocation to originators should be permitted where the L-shaped option or horizontal cash reserve account option was used as a form of risk retention.

## 2. Proposed Treatment

The agencies have carefully considered the concerns raised by commenters with respect to the original proposal on allocation to originators. The agencies do not believe, however, that a significant expansion of the allocation to originator option would be appropriate and that allocation limits on originators are necessary to realize the agencies' goal of better aligning securitizers' and investors' interests.

Therefore, the agencies are proposing an allocation to originator provision that is substantially similar to the provision in the original proposal. The only modifications to this option would be technical changes that reflect the proposed flexible standard risk retention (discussed above in Part III.B.1 of this **SUPPLEMENTARY INFORMATION**). The rule, like the original proposal, would require that an originator to which a portion of the sponsor's risk retention obligation is allocated acquire and retain ABS interests or eligible horizontal residual interests in the same manner as would have been retained by the sponsor. Under the proposed rule, this condition would require an originator to acquire horizontal and vertical interests in the securitization transaction in the same proportion as the interests originally established by the sponsor. This requirement helps to align the interests of originators and sponsors, as both face the same likelihood and degree of losses if the collateralized assets begin to default.

In addition, the proposed rule would permit a sponsor that uses a horizontal cash reserve account to use this option. Finally, consistent with the change in the general risk retention from par value to fair value (discussed above in Part III.B.1 of this **Supplementary Information**) in determining the maximum amount of risk retention that could be allocated to an originator, the current NPR refers to the fair value, rather than the dollar amount (or corresponding amount in the foreign currency in which the ABS are issued, as applicable), of the retained interests.

As explained in the original proposal, by limiting this option to originators that originate at least 20 percent of the asset pool, the agencies seek to ensure that the originator retains risk in an amount significant enough to function as an actual incentive for the originator

<sup>96</sup> 15 U.S.C. 78o–11(d)(2). The agencies note that section 15G(d) appears to contain an erroneous cross-reference. Specifically, the reference at the beginning of section 15G(d) to “subsection (c)(1)(E)(iv)” is read to mean “subsection (c)(1)(G)(iv)”, as the former subsection does not pertain to allocation, while the latter is the subsection that permits the agencies to provide for the allocation of risk retention obligations between a securitizer and an originator in the case of a securitizer that purchases assets from an originator.

to monitor the quality of all the assets being securitized (and to which it would retain some credit risk exposure). In addition, by restricting originators to holding no more than their proportional share of the risk retention obligation, the proposal seeks to prevent sponsors from circumventing the purpose of the risk retention obligation by transferring an outsized portion of the obligation to an originator that may have been seeking to acquire a speculative investment. These requirements are also intended to reduce the proposal's potential complexity and facilitate investor and regulatory monitoring.

The re-proposal again requires that an originator hold retained interests in the same manner as the sponsor. As noted, the proposed rule provides the sponsor with significant flexibility in determining the mix of vertical and horizontal interests that it would hold to meet its risk retention requirement. In addition, unlike the original proposal, the proposed rule would permit a sponsor that holds a combination of vertical and horizontal interests to utilize the allocation to originator option. If originators were permitted to retain their share of the sponsor's risk retention obligation in a proportion that is different from the sponsor's mix of the vertical and horizontal interests, investor and regulatory monitoring could become very complex.

The re-proposal does not incorporate commenters' suggestion that an originator be allocated retention in only the loans that it originated. The operational burden on both securitization sponsors and federal supervisors to ensure that retention is held by originators on the correct individual loans would be exceedingly high. Therefore, the proposal continues to require that originators allocated a portion of the risk retention requirement be allocated a share of the entire securitization pool.

The agencies are not proposing a definition of originator modified from the original proposal and are not proposing to include persons that acquire loans and transfer them to a sponsor. The agencies continue to believe that the definition of the term originator in section 15G<sup>97</sup> does not provide the agencies with flexibility to make this change. This definition limits an originator to a person that "through the extension of credit or otherwise, creates a financial asset." A person that acquires an asset created by another person would not be the "creator" of such asset.

The agencies are not proposing to eliminate the allocation to originator provision, as some commenters suggested. Although the agencies are sensitive to concerns that smaller originators might be forced to accept allocations from sponsors due to unequal bargaining power, the 20 percent threshold would make the allocation option available only for entities whose assets form a significant portion of a pool and who, thus, ordinarily could be expected to have some bargaining power with a sponsor.

Finally, the agencies do not believe that it is necessary, as some commenters suggested, to require retention by a non-sponsor originator which provides more than half of the securitized asset pool. In most circumstances, such an originator would be a sponsor. In any circumstance where such an originator was not the sponsor, the agencies believe that risk retention goals would be adequately served by retention by the sponsor, if allocation to the originator did not otherwise occur.

#### Request for Comment

71(a). If originators were allocated risk only as to the loans they originate, would it be operationally feasible to allocate losses on a loan-by-loan basis?  
71(b). What would be the degree of burden to implement such a system and accurately track and allocate losses?

#### *D. Hedging, Transfer, and Financing Restrictions*

##### 1. Overview of the Original Proposal and Public Comment

Section 15G(c)(1)(A) provides that the risk retention regulations prescribed shall prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset. Consistent with this statutory directive, the original proposal prohibited a sponsor from transferring any interest or assets that it was required to retain under the rule to any person other than an affiliate whose financial statements are consolidated with those of the sponsor (a consolidated affiliate). An issuing entity, however, would not be deemed a consolidated affiliate of the sponsor for the securitization even if its financial statements were consolidated with those of the sponsor under applicable accounting standards.

In addition to the transfer restrictions, the original proposal prohibited a sponsor or any consolidated affiliate from hedging the credit risk the sponsor was required to retain under the rule. However, hedge positions that are not

materially related to the credit risk of the particular ABS interests or exposures required to be retained by the sponsor or its affiliate would not have been prohibited under the original proposal. The original proposal also prohibited a sponsor and a consolidated affiliate from pledging as collateral for any obligation any interest or asset that the sponsor was required to retain unless the obligation was with full recourse to the sponsor or consolidated affiliate.

Commenters generally expressed support for the proposed restrictions in the original proposal as they felt that the restrictions were appropriately structured. However, several commenters recommended that sponsors only be required to maintain a fixed percentage of exposure to a securitization over time rather than a fixed amount of exposure. Some commenters also recommended that the transfer restriction be modified so that not only could sponsors transfer retained interests or assets to consolidated affiliates, but consolidated affiliates could hold the risk retention initially as well.

##### 2. Proposed Treatment

The agencies have carefully considered the comments received with respect to the original proposal's hedging, transfer, and financing restrictions, and the agencies do not believe that any significant changes to these restrictions would be appropriate (other than the exemptions provided for CMBS and duration of the hedging and transfer restrictions, as described in Part IV.F of this Supplementary Information).

The agencies are, however, proposing changes in connection with the consolidated affiliate treatment. As noted above, the "consolidated affiliate" definition would be operative in two respects. First, the original proposal would have permitted transfers of the risk retention interest to a consolidated affiliate. The agencies proposed this treatment under the rationale that financial losses are shared equally within a group of consolidated entities; therefore, a sponsor would not "avoid" losses by transferring the required risk retention asset to an affiliate. Upon further consideration, the agencies are concerned that, under current accounting standards, consolidation of an entity can occur under circumstances in which a significant portion of the economic losses of one entity will not, in economic terms, be suffered by its consolidated affiliate.

To avoid this outcome, the current proposal introduces the concept of a

<sup>97</sup> 15 U.S.C. 78o-11(a)(4).

“majority-owned affiliate,” which would be defined under the proposal as an entity that, directly or indirectly, majority controls, is majority controlled by, or is under common majority control with, another entity. For purposes of this definition, majority control would mean 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 agencies are also, in response to commenters, revising the proposal to allow risk retention to be retained as an initial matter by a majority-owned affiliate; in other words, it would not be necessary for the sponsor to go through the steps of holding the required retention interest for a moment in time before moving it to the affiliate.

Second, the original proposal prohibited a consolidated affiliate of the sponsor from hedging a risk retention interest required to be retained under the rule. Again, the rationale was that the sponsor’s consolidated affiliate would obtain the benefits of the hedging transaction and they would offset any losses sustained by the sponsor. In the current proposal, the agencies are eliminating the concept of the “consolidated” affiliate and instead applying the hedging prohibition to any affiliate of the sponsor.

In all other respects, the agencies are again proposing the same hedging, transfer, and financing restrictions as under the original proposal, without modification. The proposal would prohibit a sponsor or any affiliate from hedging the credit risk the sponsor is required to retain under the rule or from purchasing or selling a security or other financial instrument, or entering into an agreement (including an insurance contract), derivative or other position, with any other person if: (i) Payments on the security or other financial instrument or under the agreement, derivative, or position are materially related to the credit risk of one or more particular ABS interests that the retaining sponsor is required to retain, or one or more of the particular securitized assets that collateralize the asset-backed securities; 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 of one or more of the particular ABS interests or one or more of the particular securitized assets that collateralize the asset-backed securities.

Similar to the original proposal, under the proposed rule holding a security tied to the return of an index (such as the subprime ABX.HE index) would not

be considered a prohibited hedge by the retaining sponsor so long as: (1) 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 represented no more than 10 percent of the dollar-weighted average of all instruments included in the index, and (2) 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 pursuant to the proposal and that are included in the index represent, in the aggregate, no more than 20 percent of the dollar-weighted average of all instruments included in the index.

Such positions would include hedges related to overall market movements, such as movements of market interest rates (but not the specific interest rate risk, also known as spread risk, associated with the ABS interest that is otherwise considered part of the credit risk), currency exchange rates, home prices, or of the overall value of a particular broad category of asset-backed securities. Likewise, hedges tied to securities that are backed by similar assets originated and securitized by other sponsors, also would not be prohibited. On the other hand, a security, instrument, derivative or contract generally would be “materially related” to the particular interests or assets that the sponsor is required to retain if the security, instrument, derivative or contract refers to those particular interests or assets or requires payment in circumstances where there is or could reasonably be expected to be a loss due to the credit risk of such interests or assets (e.g., a credit default swap for which the particular interest or asset is the reference asset).

Consistent with the original proposal, the proposed rule would prohibit a sponsor and any affiliate from pledging as collateral for any obligation (including a loan, repurchase agreement, or other financing transaction) any ABS interest that the sponsor is required to retain unless the obligation is with full recourse to the sponsor or a pledging affiliate (as applicable). Because the lender of a loan that is not with full recourse to the borrower has limited rights against the borrower on default, and may rely more heavily on the collateral pledged (rather than the borrower’s assets generally) for repayment, a limited recourse financing supported by a sponsor’s risk retention interest may transfer some of the risk of the retained interest to the lender during the term of the loan. If the sponsor or affiliate pledged the interest or asset to

support recourse financing and subsequently allowed (whether by consent, pursuant to the exercise of remedies by the counterparty or otherwise) the interest or asset to be taken by the counterparty to the financing transaction, the sponsor will have violated the prohibition on transfer.

Similar to the original proposal, the proposed rule would not prohibit an issuing entity from engaging in hedging activities itself when such activities would be for the benefit of all investors in the asset-backed securities. However, any credit protection by or hedging protection obtained by an issuing entity could not cover any ABS interest or asset that the sponsor is required to retain under the proposed rule. For example, if the sponsor retained a 5 percent eligible vertical interest, an issuing entity may purchase (or benefit from) a credit insurance wrap that covers up to 95 percent of the tranches, but not the 5 percent of such tranches required to be retained by the sponsor.

#### Request for Comment

72(a). Is the scope of the proposed restriction relating to majority-owned affiliates, and affiliates generally, appropriate to prevent sponsors from avoiding losses arising from a risk retention asset? 72(b). Should the agencies, instead of the majority-owned affiliate approach, increase the 50 percent ownership requirement to a 100 percent ownership threshold under a wholly-owned approach?

#### IV. General Exemptions

Section 15G(c)(1)(G) and section 15G(e) of the Exchange Act require the agencies to provide a total or partial exemption from the risk retention requirements for certain types of ABS or securitization transactions.<sup>98</sup> In addition, section 15G(e)(1) permits the agencies jointly to adopt or issue additional exemptions, exceptions, or adjustments to the risk retention requirements of the rules, including exemptions, exceptions, or adjustments for classes of institutions or assets, if the exemption, exception, or adjustment would: (A) Help ensure high quality underwriting standards for the securitizers and originators of assets that are securitized or available for securitization; and (B) encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of consumers and businesses to credit on reasonable terms, or otherwise be in the public

<sup>98</sup> 15 U.S.C. 78o–11(c)(1)(G) and (e).

interest and for the protection of investors.

Consistent with these provisions, the original proposal would have exempted certain types of ABS or securitization transactions from the credit risk retention requirements of the rule, each as discussed below, along with the comments and the new or revised proposals of the proposed rule.

*A. Exemption for Federally Insured or Guaranteed Residential, Multifamily, and Health Care Mortgage Loan Assets*

The original proposal would have implemented section 15G(e)(3)(B) of the Exchange Act by exempting from the risk retention requirements any securitization transaction that is collateralized solely by residential, multifamily, or health care facility mortgage loan assets if the assets are insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States.<sup>99</sup> Also, the original proposal would have exempted any securitization transaction that involves the issuance of ABS if the ABS are insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States and that are collateralized solely by residential, multifamily, or health care facility mortgage loan assets, or interests in such assets.

Commenters on the original proposal generally believed the agencies had appropriately proposed to implement this statutory exemption from the risk retention requirement. Some commenters remarked that the broad exemptions granted to government institutions and programs, which are unrelated to prudent underwriting, are another reason that transactions securitizing loans with private mortgage insurance should be exempted because, without including private mortgage insurance, the rule may encourage excessive reliance on such exemption and undermine the effectiveness of risk retention.

Commenters also generally believed that the agencies were correct in believing the federal department or agency issuing, insuring or guaranteeing the ABS or collateral would monitor the quality of the assets securitized. One commenter noted that, in its experience, federal programs are sufficiently monitored to ensure the safety and consistency of the securitization and public interest. One commenter said that it would seem that any U.S. guarantee or insurance program should be exempt if it provides at least the

same amount of coverage as the risk retention requirement, and another commenter said that the exemption should be broad enough to cover all federal insurance and guarantee programs. One commenter noted that the exemption seemed to prevent the mixing of U.S. direct obligations and U.S. insured or guaranteed obligations because the proposed rule would only allow an exemption for transactions collateralized either solely by U.S. direct obligations or solely by assets that are fully insured or guaranteed as to the payment of principal and interest by the U.S. Certain commenters urged the agencies to extend the government-backed exemptions to ABS backed by foreign governments, similar to the European Union's risk retention regime which includes a general exemption for transactions backed by "central government" claims without restriction.

Several commenters urged the agencies to revise the government institutions and programs exemption to include an exemption for securitizations consisting of student loans made under the Federal Family Education Loan Program ("FFELP"). In particular, these commenters believe an exemption is warranted because FFELP loans have a U.S.-backed guarantee on 97 percent to 100 percent of defaulted principal and interest under the FFELP guarantee programs administered by the Department of Education. These commenters noted that FFELP loans benefit from a higher level of federal government support than Veterans Administration loans (25 percent to 50 percent) and Department of Agriculture Rural Development loans (up to 90 percent). These commenters also noted that risk retention would have no effect on the underwriting standards since these loans have been funded already and the program is no longer underwriting new loans. A securitizer of student loans also noted that the Department of Education set the standards by which FFELP loans were originated and serviced. Some commenters said that, if the agencies do not entirely exclude FFELP loan securitizations from the risk retention requirement, at a minimum the agencies should only require risk retention on the non-FFELP portion of the ABS portfolio.<sup>100</sup>

Two commenters on the original proposal urged the agencies to include an exemption for ABS collateralized by any credit instrument extended under

<sup>100</sup> One commenter requested an exemption for the sponsor of short-term notes issued by Straight-A Funding, LLC. As Straight-A Funding, LLC will not have ABS interests outstanding after January 19, 2014, such an exemption is not necessary.

the federal guarantee program for bonds and notes issued for eligible community or economic development purposes established under the Community Development Financial Institutions ("CDFI") bond program. Therefore, because credit risk retention was addressed and tailored specifically for the CDFI program, it was this commenter's view that the CDFI program transactions were designed to be exempt from the final credit risk retention requirements of section 15G of the Exchange Act in accordance with section 941(b) of the Dodd-Frank Act.

The agencies are again proposing, without changes from the original proposal, the exemption from the risk retention requirements for any securitization transaction that is collateralized solely by residential, multifamily, or health care facility mortgage loan assets if the assets are insured or guaranteed in whole or in part as to the payment of principal and interest by the United States or an agency of the United States. The agencies are also proposing, without changes from the original proposal, the exemption from the risk retention requirements for any securitization transaction that involves the issuance of ABS if the ABS are insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States and that are collateralized solely by residential, multifamily, or health care facility mortgage loan assets, or interests in such assets.

In addition, taking into consideration comments received on the original proposal, the agencies are proposing a separate provision for securitization transactions that are collateralized by FFELP loans. Under the proposed rule, a securitization transaction that is collateralized (excluding servicing assets) solely by FFELP loans that are guaranteed as to 100 percent of defaulted principal and accrued interest (*i.e.*, FFELP loans with first disbursement prior to October 1993 or pursuant to certain limited circumstances where a full guarantee was required) would be exempt from the risk retention requirements. A securitization transaction that is collateralized solely (excluding servicing assets) by FFELP loans that are guaranteed as to at least 98 percent of defaulted principal and accrued interest would have its risk retention requirement reduced to 2 percent.<sup>101</sup> This means that if the lowest guaranteed

<sup>101</sup> The definition of "servicing assets" is discussed in Part II.B of this **SUPPLEMENTARY INFORMATION**.

<sup>99</sup> *Id.* at section 780-11(e)(3)(B).

amount for any FFELP loan in the pool is 98 percent (*i.e.*, a FFELP loan with first disbursement between October 1993 and June 2006), the risk retention requirement for the entire transaction would be 2 percent. Similarly, under the proposed rule, a securitization transaction that is collateralized solely (excluding servicing assets) by FFELP loans that are guaranteed as to at least 97 percent of defaulted principal and accrued interest (in other words, all other securitizations collateralized solely by FFELP loans) would have its risk retention requirement reduced to 3 percent. Accordingly, if the lowest guaranteed amount for any FFELP loan in the pool is 97 percent (*i.e.*, a FFELP loan with first disbursement of July 2006 or later), the risk retention requirement for the entire transaction would be 3 percent.

The agencies believe this reduction in the risk retention requirement is appropriate because FFELP loans have a guarantee on 97 percent to 100 percent of defaulted principal and interest under the FFELP guarantee programs backed by the U.S. Department of Education. Further, fairly extensive post-default servicing must be properly performed under FFELP rules as a prerequisite to guarantee payment. Sponsors would therefore be encouraged to select assets for securitization with high quality underwriting standards. Furthermore, appropriate risk management practices would be encouraged as such proper post-default servicing will be required to restore the loan to payment status or successfully collect upon the guarantee.

The agencies generally are not proposing to expand general exemptions from risk retention for other types of assets, as described in commenters' requests above. The agencies are not creating an exemption for short-term promissory notes issued by the Straight-A Funding program. The agencies do not believe such an exemption is appropriate because of the termination of the FFELP program and the presence in the market of other sources of funding for student lending. Additionally, the agencies are not proposing to exempt securitization transactions that employ a mix of government-guaranteed and direct government obligations from risk retention requirements, because the agencies have not found evidence that such securitization transactions currently exist in the market and the agencies have concerns about the development of such transactions for regulatory arbitrage purposes.

The agencies are not proposing an exemption from risk retention for

securitizations of assets issued, guaranteed or insured by foreign government entities. The agencies do not believe it would be appropriate to exempt such transactions from risk retention if they were offered in the United States to U.S. investors.

Finally, the agencies are not proposing an exemption for the CDFI program, because the agencies do not believe such an exemption is necessary. It does not appear that CDFI program bonds are ABS. Although the proceeds of the bonds flow to CDFIs for use in funding community development lending, and the community development loans are ultimately the source of repayment on the bond, they do not collateralize the bonds. Furthermore, even if the bonds were ABS, the bonds are fully guaranteed by the U.S. government and therefore would qualify for other exemptions from risk retention contemplated by section 15G of the Exchange Act, discussed below.

#### *B. Exemption for Securitizations of Assets Issued, Insured, or Guaranteed by the United States or Any Agency of the United States and Other Exemptions*

Section 15G(c)(1)(G)(ii) of the Exchange Act requires that the agencies, in implementing risk retention regulations, provide for a total or partial exemption from risk retention for securitizations of assets that are issued or guaranteed by the United States or an agency of the United States, as the agencies jointly determine appropriate in the public interest and the protection of investors.<sup>102</sup> The original proposal would have contained full exemptions from risk retention for any securitization transaction if the ABS issued in the transaction were (1) collateralized solely (excluding cash and cash equivalents) by obligations issued by the United States or an agency of the United States; (2) collateralized solely (excluding cash and cash equivalents) by assets that are fully insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States (other than residential, multifamily, or health care facility mortgage loan securitizations discussed above); or (3) fully guaranteed as to the timely payment of principal and interest by the United States or any agency of the United States.

Consistent with section 15G(e)(3)(A) of the Exchange Act, the original proposal also would have provided an exemption from risk retention for any securitization transaction that is collateralized solely (excluding cash

and cash equivalents) 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.<sup>103</sup> Additionally, the original proposal provided an exemption from risk retention, consistent with section 15G(c)(1)(G)(iii) of the Exchange Act,<sup>104</sup> for securities (1) issued or guaranteed by any state of the United States, or by any political subdivision of a state or territory, or by any public instrumentality of a state or territory that is exempt from the registration requirements of the Securities Act by reason of section 3(a)(2) of the Securities Act or (2) defined as a qualified scholarship funding bond in section 150(d)(2) of the Internal Revenue Code of 1986.

Commenters on the original proposal generally believed that the proposed exemptions would appropriately implement the relevant provisions of the Exchange Act. Two commenters requested that the final rule clarify that this exemption extends to securities issued on a federally taxable as well as on a federal tax-exempt basis. Similarly, another commenter requested that the agencies make it clear that, in order to satisfy the qualified scholarship funding bond exemption, it is sufficient that the issuer be the type of entity described in the definition of qualified scholarship funding bond. One commenter did not support the broad exemption for municipal and government entities because it believed the exemption would provide an unfair advantage to public mortgage insurance that is not otherwise available to private mortgage insurance. Three commenters requested that the municipal exemption be broadened to include special purpose entities created by municipal entities because such special purpose entities are fully accountable to the public and are generally created to accomplish purposes consistent with the mission of the municipal entity.

Another commenter said that the exemption should be broadened to cover securities issued by entities on behalf of municipal sponsors because the Commission has historically, through no-action letters, deemed such securities to be exempt under section 3(a)(2) of the Securities Act. This commenter also asked that the final rule or adopting release clarify that any "separate security" under Rule 131 under the Securities Act would also be exempt under the risk retention rule.

<sup>103</sup> *Id.* at 78o-11(e)(3)(A).

<sup>104</sup> *Id.* at 78o-11(c)(1)(G)(iii).

<sup>102</sup> *Id.* at 78o-11(c)(1)(G).

One commenter stated that an exemption was appropriate in this circumstance because state and municipal issuers are required by state constitutions to carry out a “public purpose,” which excludes a profit motive.

Several commenters recommended the agencies broaden the exemption so that all state agency and nonprofit student lenders (regardless of section 150(d) qualification) would be exempt from the rule. In general, these commenters stated that an exemption would be appropriate because requiring risk retention by these entities would be unnecessary and will cause them financial distress, thus impairing their ability to carry out their public-interest mission. One commenter said that the original proposal would make an erroneous distinction between nonprofit lenders that use section 150(d) and those who do not because both types of nonprofit student lenders offer the same level of retained risk. Also, the group noted that nonprofit and state agency student lenders are chartered to perform a specific public purpose—to provide financing to prospective students who want to enroll in higher education institutions. However, one commenter did not support a broad exemption for nonprofit student lenders because there did not appear to be anything inherent in a nonprofit structure that would protect investors in securitizations. Further, this commenter noted that there have been nonprofit private education lenders whose business model differs little from for-profit lenders.

After considering the comments received, the agencies are again proposing the exemptions under section 15G(c)(1)(G)(ii) of the Exchange Act without substantive modifications from the original proposal. The agencies believe that broadening the scope of the exemption to cover private entities that are affiliated with municipal entities, but that are not themselves municipal entities, would go beyond the statutory scope of section 15G(c)(1)(G)(iii) of the Exchange Act. Similarly, the agencies are not expanding the originally proposed exemptions to cover nonprofit student loan lenders. The agencies believe that nonprofit student loan lending differs little from for-profit student loan lending and that there does not appear to be anything inherent in the underwriting practices of nonprofit student loan lending to suggest that these securitizations align interests of securitizers with interests of investors so that an exemption would be appropriate under section 15G(c)(1)(G) or section 15G(e) of the Exchange Act.

### C. Exemption for Certain Resecuritization Transactions

Under the original proposal, certain ABS issued in resecuritization transactions<sup>105</sup> (resecuritization ABS) would have been exempted from the credit risk retention requirements if they met two conditions. First, the transaction had to be collateralized solely by existing ABS issued in a securitization transaction for which credit risk was retained as required under the original proposal, or which was otherwise exempted from credit risk retention requirements (compliant ABS). Second, the transaction had to be structured so that it involved the issuance of only a single class of ABS interests and provided 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 such class of ABS. Because the holder of a resecuritization ABS structured as a single-class pass-through security would have a fractional undivided interest in the pool of underlying ABS and in the distributions of principal and interest (including prepayments) from these underlying ABS, the agencies reasoned that a resecuritization ABS meeting these requirements would not alter the level or allocation of credit and interest rate risk on the underlying ABS.

In the original proposal, the agencies proposed to adopt this exemption under the general exemption provisions of section 15G(e)(1) of the Exchange Act.<sup>106</sup> The agencies noted that a resecuritization transaction that created a single-class pass-through would neither increase nor reallocate the credit risk inherent in that underlying compliant ABS, and that the transaction could allow for the combination of ABS backed by smaller pools, and the creation of ABS that may be backed by more geographically diverse pools than those that can be achieved by the pooling of individual assets. As a result, the exemption for this type of resecuritization could improve the

<sup>105</sup> In a resecuritization transaction, the asset pool underlying the ABS issued in the transaction comprises one or more asset-backed securities.

<sup>106</sup> As discussed above in Part IV of this SUPPLEMENTARY INFORMATION, the agencies may jointly adopt or issue exemptions, exceptions, or adjustments to the risk retention rules, if such exemption, exception, or adjustment would: (A) Help ensure high quality underwriting standards for the securitizers and originators of assets that are securitized or available for securitization; and (B) encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of consumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors. 15 U.S.C. 78o–11(e)(1).

access of consumers and businesses to credit on reasonable terms.<sup>107</sup>

Under the original proposal, sponsors of resecuritizations that were not structured purely as single-class pass-through transactions would have been required to meet the credit risk retention requirements with respect to such resecuritizations unless another exemption for the resecuritization was available. Thus, the originally proposed rule would subject resecuritizations to separate risk retention requirements that separate the credit or pre-payment risk of the underlying ABS into new tranches.<sup>108</sup>

The agencies received a number of comments on the resecuritization exemption in the original proposal, principally but not exclusively from financial entities and financial trade organizations. The commenters, including investor members of one trade organization, generally favored expanding the resecuritization exemption and allowing greater flexibility in these transactions, although individual commenters differed in how broad a new exemption should be. Further, while many commenters generally supported the first criterion for the proposed exemption that the ABS used in the resecuritization must be compliant with, or exempt from, the risk retention rules, they did not support the second criterion that only a single class pass-through be issued in the resecuritization transaction for the proposed exemption to apply. In particular, they did not believe that this condition would

<sup>107</sup> See Original Proposal, 76 FR at 24138.

<sup>108</sup> For example, under the proposed rules, the sponsor of a CDO would not meet the proposed conditions of the exemption and therefore would be required to retain risk in accordance with the rule with respect to the CDO, regardless of whether the underlying ABS have been drawn exclusively from compliant ABS. See 15 U.S.C. 78o–11(c)(1)(F). In a typical CDO transaction, a securitizer pools interests in the mezzanine tranches from many existing ABS and uses that pool to collateralize the CDO. Repayments of principal on the underlying ABS interests are allocated so as to create a senior tranche, as well as supporting mezzanine and equity tranches of increasing credit risk. Specifically, as periodic principal payments on the underlying ABS are received, they are distributed first to the senior tranche of the CDO and then to the mezzanine and equity tranches in order of increasing credit risk, with any shortfalls being borne by the most subordinate tranche then outstanding.

Similarly, with regard to ABS structured to protect against pre-payment risk or that are structured to achieve sequential paydown of tranches, the agencies reasoned that although losses on the underlying ABS would be allocated to holders in the resecuritization on a *pro rata* basis, holders of longer duration classes in the resecuritization could be exposed to a higher level of credit risk than holders of shorter duration classes. See Original Proposal, 76 FR at 24138 n.193.

further the goal of improving underwriting of the underlying assets, although they believed that it would unnecessarily restrict a source of liquidity in the market place.

A few commenters asserted that applying risk retention to resecuritization of ABS that are already in the market place, whether or not the interests are compliant ABS, cannot alter the incentives for the original ABS sponsor to create high-quality assets. Some commenters also stated that resecuritizations allowed the creation of specific tranches of ABS interests, such as planned asset class securities, or principal or interest only strips, that are structured to meet specific demands of investors, so that subjecting such transactions to additional risk retention (possibly discouraging the issuance of such securities) could prevent markets from efficiently fulfilling investor needs. Commenters also noted that resecuritization transactions allow investors to sell ABS interests that they may no longer want by creating assets that are more highly valued by other investors, thereby improving the liquidity of these assets. Another commenter advised that the rule should encourage resecuritizations that provided additional collateral or enhancements such as insurance policies for the resecuritization ABS. Another commenter noted that resecuritizations of mortgage backed securities were an important technical factor in the recent run up in prices and that requiring additional risk retention would chill the market unnecessarily.

Some comments suggested that the agencies should expand the exemption to some common types of resecuritizations, but not apply it to CDOs. To distinguish which should be subject to the exemption, commenters suggested not extending the exemption to transactions with managed pools of collateral, or limiting the types or classes of ABS that could be resecuritized, and the derivatives an issuing entity could use. A few commenters specifically stated that the resecuritization exemption should be extended to include sequential pay resecuritizations or resecuritizations structured to address prepayment risk, if they were collateralized by compliant ABS. Another commenter recommended that the exemption include any tranching of resecuritizations (such as typical collateralized mortgage obligations) of ABS issued or guaranteed by the U.S. government, the Government National Mortgage Associations or the Enterprises, as these instruments were an important source of liquidity for the underlying assets.

Finally, one commenter requested clarification as to whether the resecuritizations of Enterprise ABS, guaranteed by the Enterprises, would be covered by the provision for Enterprises in the original proposal. The agencies are clarifying that to the extent the Enterprises act as sponsor for a resecuritization of their ABS, fully guarantee the resulting securities as to principal and interest, and meet the other conditions the agencies are again proposing, that provision would apply to the Enterprise securitization transaction.<sup>109</sup>

The agencies continue to believe that the resecuritization exemption from the original proposal is appropriate for the reasons discussed in that proposal, and above. Accordingly, the agencies are again proposing this provision without substantive change. Additionally, the agencies have carefully considered comments asking for expansion of the resecuritization exemption. In this respect, the agencies have considered that sponsors of resecuritization transactions would have considerable flexibility in choosing what ABS interests to include in an underlying pool as well as in creating the specific structures. This choice of securities is essentially the underwriting of those securities for selection in the underlying pool. The agencies consider it appropriate, therefore, to propose rules that would provide sponsors with sufficient incentive to choose ABS that have lower levels of credit risk and to not use a resecuritization to obscure what might have been sub-par credit performance of certain ABS. It is also appropriate to apply the risk retention requirements in resecuritization transactions because resecuritization transactions can result in re-allocating the credit risk of the underlying ABS interest. Taking into account these considerations, the agencies believe that requiring additional risk retention as the standard for most resecuritization transactions is consistent with the intent of section 15G of the Exchange Act, both in light of recent history and the specific statutory requirement that the agencies adopt risk retention standards for CDOs, and similar instruments collateralized by ABS.<sup>110</sup>

The agencies note that to qualify for the proposed resecuritization exemptions, the ABS that are resecuritized would have to be

<sup>109</sup> See proposed rule at § \_\_.8. The wording of the provision as proposed is not limited to just initial Enterprise-sponsored securitization transactions but would also apply to ABS created by Enterprise-sponsored resecuritizations, as long as all the proposed conditions are met.

<sup>110</sup> See 15 U.S.C. 780–11(c)(1)(F).

compliant ABS. As the agencies noted in the original proposal, section 15G of the Exchange Act would not apply to ABS issued before the effective date of the agencies' final rules,<sup>111</sup> and that as a practical matter, private-label ABS issued before the effective date of the final rules would typically not be compliant ABS. ABS issued before the effective date that meet the terms of an exemption from the proposed rule or that are guaranteed by the Enterprises, however, could qualify as compliant ABS.

The agencies also do not believe that many of the commenters' suggestions for distinguishing "typical" resecuritizations from CDOs or other higher risk transactions could be applied consistently across transactions. The agencies, however, are proposing a modification to the original proposal in an effort to address comments about liquidity provision to the underlying markets and access to credit on reasonable terms while remaining consistent with the purpose of the statute. Certain RMBS resecuritizations are designed to address pre-payment risk for RMBS, because RMBS tend to have longer maturities than other types of ABS and high pre-payment risk. In this market, investors often seek securities structured to protect against pre-payment risk and have greater certainty as to expected life. At the same time, these resecuritizations do not divide again the credit risk of the underlying ABS with new tranches of differing subordination and therefore do not give rise to the same concerns as CDOs and similar resecuritizations that involve a subsequent tranching of credit risk.

Accordingly, the agencies are proposing a limited expansion of the resecuritization exemption to include certain resecuritizations of RMBS that are structured to address pre-payment risk, but that do not re-allocate credit risk by tranching and subordination structures. To qualify for this exemption, the transaction would be required to meet all of the conditions set out in the proposed rule. First, the transaction must be a resecuritization of first-pay classes of ABS, which are themselves collateralized by first-lien residential mortgage located in a state of the United States or its territories.<sup>112</sup>

<sup>111</sup> See *id.* at section 780–11(i) (regulations become effective with respect to residential mortgage-backed ABS one year after publication of the final rules in the **Federal Register**, and two years for all other ABS).

<sup>112</sup> Section 2 of the proposed rule defines "state" as having the same meaning as in section 3(a)(16) of the Securities Exchange Act of 1934 (15 U.S.C.

The proposal would define “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 closing of the transaction, are entitled to repayments of principal and payments of interest prior to or pro-rata, except for principal-only and interest only tranches that are prior in payment, 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.<sup>113</sup> The proposed rule also would allow a pool collateralizing an exempted securitization to contain servicing assets.<sup>114</sup>

In addition, the proposed rule would require that the first-pay classes of ABS used in the securitization transaction consist of compliant ABS. Further, to qualify for the exemption any ABS interest issued in the securitization would be required to share pro rata in any realized principal losses with all other ABS holders of ABS interests issued in the securitization based on the unpaid principal balance of such interest at the time the loss is realized.

The proposed rule would also require the transaction to be structured to reallocate pre-payment risk and specifically would prohibit any structure which re-allocates credit risk (other than credit risk reallocated only as a collateral consequence of reallocating pre-payment risk). It would also prohibit the issuance of an inverse floater or any similarly structured class of ABS as part of the exempt securitization transaction. The proposal would define “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.

The exclusion from the proposed exemption of transactions involving the issuance of an inverse floater class would address the high risk of loss that

has been associated with these instruments.

The agencies are proposing the expanded exemptions from risk retention for resecuritizations of first-pay classes of RMBS under the general exemption provisions of section 15G(e)(1) of the Exchange Act, and believe that the provision is consistent with the requirements of this section. The provisions that would limit the exemption to resecuritizations of first-pay classes of RMBS, and the specific prohibitions on structures that re-allocate credit risk, would also help minimize credit risk associated with the resecuritization ABS and prevent the transaction from reallocating existing credit risk.

#### Request for Comment

73(a). Would the issuance of an inverse floater class of ABS be necessary to properly structure other classes of ABS to provide adequate pre-payment protection for investors as part of the securitization transaction? 73(b). Would this prohibition frustrate the goals of the proposed exemption?

#### D. Other Exemptions From Risk Retention Requirements

In the original proposal, the agencies’ requested comment about whether there were other securitization transactions not covered by the exemptions in the original proposal that should be exempted from risk retention. The agencies received requests from commenters for exemptions from risk retention for some types of assets, as discussed below. After carefully considering the comments, the agencies are proposing some additional exemptions from risk retention that were not included in the original proposal.

##### 1. Utility Legislative Securitizations

Some commenters on the original proposal requested that the agencies exempt ABS issued by regulated electric utilities that are backed by stranded costs, transition property, system restoration property and other types of property specifically created or defined for regulated utility-related securitizations by state legislatures (utility legislative securitizations). These commenters asserted that risk retention for these transactions would not encourage better underwriting or otherwise promote the purposes of the risk retention requirement, because a utility legislative securitization can generally only occur after findings by a state legislature and a public service commission that it is desirable in the interest of utility consumers and after

utility executives representing the utility’s investors seek such financing. According to commenters, the structure is used to minimize the costs of financing significant utility-related costs, and the increase in the cost of such financing that would result from risk retention would not be warranted, because it would not affect credit quality of the underlying assets. Further, commenters asserted that this type of financing avoids the risk of poor underwriting standards, adverse selection and minimizes credit risk, because the utility sponsor does not choose among its customers for inclusion or exclusion from the transaction and because the financing order mechanism, or choose order of repayment.

The agencies have considered these comments and are proposing to provide an exemption from risk retention for utility legislative securitizations. Specifically, the re-proposed rule would exempt any securitization transaction 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. Additionally, ABS issued in an exempted transaction would be required to be secured by the intangible property right to collect charges for the recovery of specified costs and such other assets of the issuing entity. The proposed rule would define “specified cost” to mean any cost identified by a state legislature as appropriate for recovery through securitization pursuant to “specified cost recovery legislation,” which is legislation enacted by a state that:

- Authorizes the investor-owned utility company to apply for, and authorized 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;
- 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 non-bypassable 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
- Guarantees that neither the state nor any of its agencies has the authority to

78c(a)(16)). Thus, the mortgages underlying the ABS interest that would be re-secured in a transaction exempted under this provision must be on property located in a state of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States.

<sup>113</sup> A single class pass-through ABS under which an investor would have a fractional, undivided interest in the pool of mortgages collateralizing the ABS would qualify as a “first pay class” under this definition.

<sup>114</sup> The proposed definition of “servicing assets” is discussed in Part II of this Supplementary Information.

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.<sup>115</sup>

As a general matter, the agencies believe that, although it falls somewhat short of being an explicit state guarantee, the financing order mechanism typical in utility legislative securitizations (by which, under state law, the state periodically adjusts the amount the utility is authorized to collect from users of its distribution network) would ensure to a sufficient degree that adequate funds are available to repay investors.

## 2. Seasoned Loans

Some commenters on the original proposal urged the agencies to create an exemption for securitizations of loans that were originated a significant period of time prior to securitization (seasoned loans) and that had remained current, because underwriting quality would no longer be as relevant to the credit performance of such loans. Commenters representing different groups provided different suggestions on the length of time required for a loan to be seasoned: sponsors representing issuers suggested a two-year seasoning period for all loans, whereas commenters representing investors suggested fully amortizing fixed-rate loans should be outstanding and performing for three years and for adjustable-rate loans the time period should depend on the reset date of the loan.

The agencies believe that risk retention as a regulatory tool to promote sound underwriting is less relevant after loans have been performing for an extended period of time. Accordingly, for reasons similar to the sunset provisions in section 12(f) of the proposed rule (as discussed in Part IV.F of this Supplementary Information), the agencies are proposing an exemption from risk retention for securitizations of seasoned loans that is similar to the sunset provisions. The proposed rule would exempt any securitization transaction that is collateralized solely (excluding servicing assets) by seasoned loans that (1) have not been modified since origination and (2) have never

been delinquent for 30 days or more.<sup>116</sup> With respect to residential mortgages, the proposed rule would define “seasoned loan” to mean a residential mortgage loan that either (1) has been outstanding and performing for the longer of (i) five years or (ii) the period until the outstanding principal balance of the loan has been reduced to 25 percent of the original principal balance; or (2) has been outstanding and performing for at least seven years. For all other asset classes, the proposed rule would define “seasoned loan” to mean a loan that has been outstanding and performing for the longer of (1) two years, or (2) the period until the outstanding principal balance of the loan has been reduced to 33 percent of the original principal balance.

## 3. Legacy Loan Securitizations

Some commenters on the original proposal recommended an exemption from risk retention for securitizations and resecuritizations of loans made before the effectiveness of the final rule, or legacy loans, arguing that risk retention would not affect the underwriting standards used to create those loans.

The agencies are not proposing to provide an exemption from risk retention for securitizations of loans originated before the effective date of the rule (legacy loans). The agencies do not believe that such securitizations should be exempt from risk retention because underwriting occurred before the effective date of the rule. The agencies believe that requiring risk retention does affect the quality of the loans that are selected for a securitization transaction, as the risk retention requirements are designed to incentivize securitizers to select well-underwritten loans, regardless of when those loans were underwritten. Furthermore, the agencies do not believe that exempting securitizations of legacy loans from risk retention would satisfy the statutory criteria for an exemption under 15G(e) of the Exchange Act.<sup>117</sup>

## 4. Corporate Debt Repackagings

Several commenters urged the agencies to adopt an exemption from risk retention for “corporate debt repackaging”<sup>118</sup> securitization

transactions. One commenter asserted that currently in corporate debt repackaging transactions, depositors and sponsors do not hold any interest in the repackaging vehicle. These commenters asserted that sponsors would not pursue corporate debt repackagings if they were required to retain risk, because it would fundamentally change the dynamics of these transactions and could raise accounting and other issues. Another commenter observed that corporate debt obligations are, generally, full recourse obligations of the issuing company and the issuer of the corporate bonds bears 100 percent of the credit risk. The commenters stated that adding an additional layer of risk retention to a repackaging of obligations that are themselves the subject of 100 percent risk retention by requiring the sponsor of the repackaging transaction to retain an additional 5 percent of the credit risk would serve no regulatory purpose. Another commenter asserted that not granting an exemption for corporate debt repackagings would reduce the ability of investors to invest in tailored repackaged securities and likewise reduce funding and liquidity to the detriment of access of businesses to credit on reasonable terms.

The agencies are not proposing an exemption from risk retention for corporate debt repackagings. The agencies do not believe an exemption is warranted because the underlying assets (the corporate bonds) are not ABS. Regardless of the level of credit risk a corporate debt issuer believes it holds on its underlying corporate bonds, the risk retention requirement would apply at the securitization level, and the sponsor of the securitization should be required to hold 5 percent of the credit risk of the securitization transaction. Risk retention at the securitization level for corporate debt repackagings aligns the sponsor’s interests in selecting the bonds in the pool with investors in the securitization, who are often retail investors.

## 5. “Non-Conduit” CMBS Transactions

Some commenters on the original proposal requested that the agencies include an exemption or special treatment for “non-conduit” CMBS transactions. Examples of “non-conduit” CMBS transactions include single-asset transactions; single-borrower transactions; large loan transactions (fixed and floating) with pools of one to 10 loans; and large loan transactions having only an investment-grade component. Commenters asserted that, because such transactions involve very small pools of loans (or a single loan), a prospective investor is able to

<sup>115</sup> The eligibility standards for the exemption are similar to certain requirements for these securitizations outlined in IRS Revenue Procedure 2005–62, 2005–2 C.B. 507, that are relevant to risk retention. This Revenue Procedure outlines the Internal Revenue Service’s requirements in order to treat the securities issued in these securitizations as debt for tax purposes, which is the primary motivation for states and public utilities to engage in such securitizations.

<sup>116</sup> The definition of “servicing assets” is discussed in Part II.B of this **SUPPLEMENTARY INFORMATION**.

<sup>117</sup> See 15 U.S.C. 780–11(e).

<sup>118</sup> According to commenters, corporate debt repackagings are created by the deposit of corporate debt securities purchased by the sponsoring institution in the secondary market into a trust which issues certificates backed by cash flows on the underlying corporate bonds.

scrutinize each loan and risk retention would be unnecessary for investor protection. In particular, commenters noted that the CMBS menu option would work only for “conduit” CMBS securitizations in which originators of commercial mortgage loans aggregate loan pools of 10 to 100 loans.

Suggestions for the treatment of “non-conduit” CMBS transactions included:

- Providing a complete exemption for single-asset transactions; single-borrower transactions; large loan transactions (fixed and floating) with pools of one to 10 loans; and large loan transactions having only an investment-grade component;
- Allowing mezzanine loans in single borrower and floating rate CMBS transactions to satisfy the risk retention requirement and any PCCRA requirements; and
- Exempting single borrower and large loan transactions with less than a certain number of loans.

The agencies are not proposing an exemption from risk retention for “non-conduit” CMBS securitizations. While the agencies do not dispute that the smaller pools of loans in these transaction allow for fuller asset-level disclosure in offering documents and could allow prospective investors the opportunity to review each loan in the pool, the agencies do not believe that this fact alone is sufficient grounds to satisfy the exemption standards of section 15G of the Exchange Act. Furthermore, the agencies do not believe that there are significant differences between “conduit” and “non-conduit” CMBS to warrant a special exemption for “non-conduit” CMBS.

#### 6. Tax Lien-Backed Securities Sponsored by a Municipal Entity

One commenter on the original proposal asserted that tax lien-backed securitizations are not ABS under the Exchange Act and should not be subject to risk retention requirement. According to this commenter, under state and municipal law, all property taxes, assessment and sewer and water charges become liens on the day they become due and payable if unpaid. These taxes, assessments and charges, and any related tax liens, arise by operation of law and do not involve an extension of credit by any party or any underwriting decision on the party of the city. If the agencies disagreed with the position that tax lien securitizations are not ABS, this commenter requested that the agencies provide a narrowly tailored exemption for any tax lien-backed securitization transactions sponsored by a municipality. In this regard, the

commenter argued that such securitizations do not involve any of the public policy concerns underlying the risk retention requirement because the tax liens arise by operation of law and do not involve an extension of credit or underwriting decisions on the part of the city. As a result, this commenter stated that applying the credit risk retention rules would not further the agencies’ stated goals of encouraging prudent underwriting standards and ensuring the quality of the assets underlying a securitization transaction.

The agencies are not proposing an exemption from risk retention for securitizations of tax lien-backed securities sponsored by municipal entities. The agencies believe that there is insufficient data to justify granting a specific exemption. Furthermore, the agencies are concerned that this type of exemption could end up being overly broad in its application and be used to exempt sponsors of securitizations of securities from programs, such as Property Assessed Clean Energy programs, that use a securitized “tax lien” structure to fund and collect consensual financing for property improvements desired by private property owners.

#### 7. Rental Car Securitizations

One commenter on the original proposal requested that the agencies exempt rental car securitizations because of the extensive overcollateralization required to support a rental car securitization, the on-going structural protections with respect to collateral valuation, and the importance of the vehicles to the business operations of the car rental operating company.

The agencies are not proposing an exemption from risk retention for rental car securitizations. Risk retention is required of other sponsors that similarly rely on securitization for funding and that sponsor securitizations with similar overcollateralization protections and structural features. The agencies do not believe that there are particular features of this type of securitization that would warrant an exemption under the factors that the agencies must consider in section 15G(e) of the Exchange Act.

#### E. Safe Harbor for Foreign Securitization Transactions

The original proposal included a “safe harbor” provision for certain securitization transactions based on the limited nature of the transactions’ connections with the United States and U.S. investors (foreign securitization transactions). The safe harbor was intended to exclude from the proposed

risk retention requirements transactions in which the effects on U.S. interests are sufficiently remote so as not to significantly impact underwriting standards and risk management practices in the United States or the interests of U.S. investors. Accordingly, the conditions for use of the safe harbor limited involvement by persons in the United States with respect to both assets being securitized and the ABS sold in connection with the transaction. Finally, as originally proposed, the safe harbor would not have been available for any transaction or series of transactions that, although in technical compliance with the conditions of the safe harbor, was part of a plan or scheme to evade the requirements of section 15G Exchange Act and the proposed rules.

As set forth in the original proposal, the risk retention requirement would not apply to a securitization transaction if: (1) The securitization transaction is not required to be and is not registered under the Securities Act; (2) no more than 10 percent of the dollar value by proceeds (or equivalent if sold in a foreign currency) of all classes of ABS interests sold in the securitization transaction are sold to U.S. persons or for the account or benefit of U.S. persons; (3) neither the sponsor of the securitization transaction nor the issuing entity is (i) chartered, incorporated, or organized under the laws of the United States, or a U.S. state or territory or (ii) the unincorporated branch or office located in the United States of an entity not chartered, incorporated, or organized under the laws of the United States, or a U.S. state or territory (collectively, a U.S.-located entity); (4) no more than 25 percent of the assets collateralizing the ABS sold in the securitization transaction were acquired by the sponsor, directly or indirectly, from a consolidated affiliate of the sponsor or issuing entity that is a U.S.-located entity.<sup>119</sup>

Commenters on the original proposal generally favored the creation of a safe harbor for certain foreign securitizations. Several commenters, however, requested that the exemption be broadened. Specifically, several commenters noted that the U.S. risk retention rules may be incompatible with foreign risk retention requirements, such as the European Union risk retention requirements, and requested that the safe harbor be modified to more readily facilitate cross-border compliance with varied foreign risk retention requirements.

<sup>119</sup> See *infra* note 112 for the definition of “state.”

Several commenters supported a mutual recognition system for some cross-border offerings. For example, commenters recommended various methodologies for establishing a mutual recognition framework that would permit non-U.S. securitizers to either satisfy or be exempt from U.S. risk retention requirements if a sufficient minimum amount of a foreign securitization complies with foreign risk retention requirements that would be recognized under such a framework. A few commenters recommended that in the absence of a mutual recognition framework, a higher proceeds limit threshold of 30 percent, or as much as 33 percent, would be more appropriate to preserve cross-border market liquidity, in at least some circumstances. A few commenters also requested clarification of how the percentage value of ABS sold to U.S. investors under the 10 percent proceeds limit should be calculated.

The agencies are proposing a foreign safe harbor that is similar to the original proposal but modified to address some commenter concerns. The proposal makes a revision to the safe harbor eligibility calculation to clarify that interests retained by the sponsor may be included in calculating the percentage of ABS interests sold in the securitization transaction that are sold to U.S. persons or for the account or benefit of U.S. persons. The proposed safe harbor eligibility calculation also would clarify that any ABS transferred to U.S. persons or for the account or benefit of U.S. persons, including U.S. affiliates of non-U.S. sponsors, must be included in calculating eligibility for the safe harbor.

The agencies are again proposing a 10 percent limit on the value of classes of ABS sold to U.S. persons for safe harbor eligibility, similar to the original proposal. The agencies continue to believe that the proposed 10 percent limit appropriately aligns the safe harbor with the objective of the rule, which is to exclude only those transactions with limited effect on U.S. interests, underwriting standards, risk management practices, or U.S. investors.

In addition, the agencies are concerned that expansion of the 10 percent limit would not effectively address the concerns of foreign securitization sponsors, some of whom rely extensively on U.S. investors for liquidity. However, the agencies also believe that the proposed rule incorporates sufficient flexibility for sponsors with respect to forms of eligible risk retention to permit foreign sponsors seeking a significant U.S. investor base to retain risk in a format

that satisfies home country and U.S. regulatory requirements. For example, in response to comments from mortgage securitizers in the United Kingdom who use revolving trust structures, the agencies are proposing to permit seller's interest to qualify as risk retention for revolving master trusts securitized by non-revolving assets. The agencies' revisions to the original proposal that are designed to provide flexibility to foreign securitization sponsors that use the revolving master trust structure are discussed in detail in Part III.B.2 of this **SUPPLEMENTARY INFORMATION**.

The agencies considered the comments requesting a mutual recognition framework and observe that such a framework has not been generally adopted in non-U.S. jurisdictions with risk retention requirements. The agencies believe that given the many differences between jurisdictions, finding comparability among securitization frameworks that place the obligation to comply with risk retention requirements upon different parties in the securitization transaction, have different requirements for hedging, risk transfer, or unfunded risk retention, or otherwise vary materially, it likely would not be practicable to construct such a "mutual recognition" system that would meet all the requirements of section 15G of the Exchange Act. Moreover, in several such jurisdictions, the risk retention framework recognizes unfunded forms of risk retention, such as standby letters of credit, which the agencies do not believe provide sufficient alignment of incentives and have rejected as eligible forms of risk retention under the U.S. framework.

#### Request for Comment

74. Are there any extra or special considerations relating to these circumstances that the agencies should take into account?

75(a). Should the more than 10 percent proceeds trigger be higher or lower (e.g., 0 percent, 5 percent, 15 percent, or 20 percent)? 75(b). If so, what should the trigger be and why? 75(c). Are the eligibility calculations appropriate? 75(d). If not, how should they be modified?

#### F. Sunset on Hedging and Transfer Restrictions

As discussed in Part III.D of this **SUPPLEMENTARY INFORMATION**, Section 15G(c)(1)(A) of the Exchange Act provides that sponsors may not hedge or transfer the risk retention interest they are required to hold.<sup>120</sup>

<sup>120</sup> 15 U.S.C. 78o-11(c)(1)(A). As with other provisions of risk retention, the agencies could

The agencies originally proposed that sponsors generally would have to hold risk retention for the duration of a securitization transaction. The proposal did not provide any sunset provisions after which the prohibitions on sale and hedging of retained interests would expire, though the proposal did specifically include a question related to including a sunset provision in the final rule and requested commenter feedback.

While a few commenters representing the investor community expressed support for risk retention for the life of the security, the majority of commenters who discussed this topic in their letters opposed risk retention lasting for the duration of the transaction. Generally, these commenters argued that credit losses on underlying assets due to poor underwriting tend to occur in the first few years of the securitization and that defaults occur less frequently as the assets are seasoned. Additionally, they asserted that the risk retention requirement as proposed would reduce liquidity in the financial system and increase the amount of capital banks would be required to hold, thereby reducing credit availability and raising borrowing costs for consumers and businesses. Thus, they argued, a sunset provision should be included in the final rule to help offset the costs and burden created by the retention requirement. After the mandated risk retention period, sponsors or their consolidated affiliates would be allowed to hedge or transfer to an unaffiliated third party the retained interest or assets.

Commenters proposed a variety of suggestions for incorporating a sunset provision in the final rule. Some favored a blanket risk retention provision, whereby retention of the interest would no longer be required after a certain period of time, regardless of the asset class. They stated that a blanket sunset requirement would be the easiest to implement and dovetails with the agencies' stated goal of reducing regulatory complexity. Among those commenters advocating for a blanket sunset, most stated that a three year sunset provision would be ideal. A subset of these commenters acknowledged that three years could be too long for some asset classes (such as automobile ABS), however they maintained that historical loss rates show that this duration would be appropriate for some of the largest asset classes, in particular CMBS and RMBS. They stated that, after three years, losses

provide an exemption under section 15G(e) of the Exchange Act if certain findings were met. *See id.* at section 78o-11(e).

related to underwriting defects have already occurred and any future credit losses are typically attributed to financial events or, in the case of RMBS, life events such as illness or unemployment, unrelated to the underwriting quality. One commenter estimated that a three-year sunset would reduce the costs associated with risk retention by 50 percent.

Other commenters suggested that the sunset provision should vary by asset class. While this might be more operationally complex to implement than a blanket sunset provision, they stated it would be more risk sensitive as it would take into account the fact that different asset classes have varying default rates and underlying exposure durations (for example, 30 years for a standard residential mortgage versus five years for a typical automobile loan). For example, commenters suggested a range of risk retention durations for RMBS, stating that anywhere from two to five years would be appropriate. Another commenter advocated that the risk retention requirement for RMBS should end at the later of five years or when the pool is reduced to 25 percent of its original balance. Similarly for CMBS, some commenters suggested requiring risk retention for only two or three years in the final rule. A few commenters stated that a sunset provision should be based upon the duration of the asset in question. For instance, one commenter stated that automobile ABS should have a sunset provision of less than five years since automobile loans are of such a short duration, while another commenter advocated using the average pool duration to determine the length of required risk retention.

The agencies have carefully considered the comments, as well as other information on credit defaults for various asset classes in contemplating whether a limit on the duration of the risk retention requirement would be appropriate. The agencies have concluded that the primary purpose of risk retention—sound underwriting—is less likely to be effectively promoted by risk retention requirements after a certain period of time has passed and a peak number of delinquencies for an asset class has occurred.

Accordingly, the agencies are proposing two categories of duration for the transfer and hedging restrictions under the proposed rule—one for RMBS and one for other types of ABS. For all ABS other than RMBS, the transfer and hedging restrictions under the rule would expire on or after the date that is the latest of (1) the date on which the total unpaid principal balance of the

securitized assets that collateralize the securitization is reduced to 33 percent of the original unpaid principal balance as of the date of the closing of the securitization, (2) the date on which the total unpaid principal obligations under the ABS interests issued in the securitization is reduced to 33 percent of the original unpaid principal obligations at the closing of the securitization transaction, or (3) two years after the date of the closing of the securitization transaction.

Similarly, the agencies are proposing, as an exception to the transfer and hedging restrictions of the proposed rule and section 15G of the Exchange Act, to permit the transfer of the retained B-piece interest from a CMBS transaction by the sponsor or initial third-party purchaser to another third-party purchaser five years after the date of the closing of the securitization transaction, provided that the transferee satisfies each of the conditions applicable to the initial third-party purchaser under the CMBS option (as described above in Part III.B.5 of this **SUPPLEMENTARY INFORMATION**).

The agencies believe the exemptions to the prohibitions on transfer and hedging for both non-residential mortgage ABS and CMBS would help ensure high quality underwriting standards for the securitizers and originators of non-residential mortgage ABS and CMBS, would improve the access of consumers and businesses to credit on reasonable terms, and are in the public interest and for the protection of investors—and thus satisfy the conditions for exceptions to the rule.<sup>121</sup> After losses due to underwriting quality occur in the initial years following a securitization transaction, risk retention does little to improve the underwriting quality of ABS as most subsequent losses are related to financial events or, in the case of RMBS, life events not captured in the underwriting process. In addition, these exemptions would improve access to credit for consumer and business borrowers by increasing potential liquidity in the non-residential mortgage ABS and CMBS markets.

Because residential mortgages typically have a longer duration than other assets, weaknesses in underwriting may show up later than in other asset classes and can be masked by strong housing markets. Moreover, residential mortgage pools are uniquely sensitive to adverse selection through prepayments: If market interest rates fall, borrowers refinance their mortgages and prepay their existing mortgages, but refinancing is not available to borrowers

whose credit has deteriorated, so the weaker credits become concentrated in the RMBS pool in later years.

Accordingly, the agencies are proposing a different sunset provision for RMBS backed by residential mortgages that are subject to risk retention. Under the rule, risk retention requirements with respect to RMBS would end on or after the date that is the later of (1) five years after the date of the closing of the securitization transaction or (2) the date on which the total unpaid principal balance of the residential mortgages that collateralize the securitization is reduced to 25 percent of the original unpaid principal balance as of the date of the closing of the securitization. In any event, risk retention requirements for RMBS would expire no later than seven years after the date of the closing of the securitizations transaction.

The proposal also makes clear that the proposed rule's restrictions on transfer and hedging end if a conservator or receiver of a sponsor or other holder of risk retention is appointed pursuant to federal or state law.

#### Request for Comment

76(a). Are the sunset provisions appropriately calibrated for RMBS (*i.e.*, later of five years or 25 percent, but no later than seven years) and all other asset classes (*i.e.*, later of two years or 33 percent)? 76(b). If not, please provide alternative sunset provision calibrations and any relevant analysis to support your assertions.

77(a). Is it appropriate to provide a sunset provision for all RMBS, as opposed to only amortizing RMBS? 77(b). Why or why not? 77(c). What effects might this have on securitization market practices?

#### G. Federal Deposit Insurance Corporation Securitizations

The agencies are proposing an additional 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 Title II of the Dodd-Frank Act. This new exemption is being proposed because such exemption would help ensure high quality underwriting and is in the public interest and for the protection of investors.<sup>122</sup> These receivers and conservators perform a function that benefits creditors in liquidating and maximizing the value of assets of failed financial institutions for the benefit of creditors and, accordingly, their actions are guided by sound underwriting

<sup>121</sup> 15 U.S.C. 78o–11(e)(2).

<sup>122</sup> See 15 U.S.C. 78o–11(e).

practices. Such receivers and conservators do not originate loans or other assets and thus are not engaged in “originate to distribute” activities that led to poorly underwritten loans and that were a significant reason for the passage of section 941 of the Dodd-Frank Act. The quality of the assets securitized by these receivers and conservators and the ABS collateralized by those assets will be carefully monitored and structured so as to be consistent with the relevant statutory authority. Moreover, this exemption is in the public interest because it would, for example, allow the FDIC to maximize the value of assets of a conservatorship or receivership and thereby reduce the potential costs of financial institution failures to creditors.

#### **V. Reduced Risk Retention Requirements and Underwriting Standards for ABS Backed by Qualifying Commercial, Commercial Real Estate, or Automobile Loans**

As contemplated by section 15G of the Exchange Act, the original proposal included a zero risk retention requirement, or exemption, for securitizations of commercial loans, commercial real estate loans, and automobile loans that met specific proposed underwriting standards.<sup>123</sup> All three categories of proposed underwriting standards contained two identical requirements. First, a securitization exempt from risk retention under these proposed provisions could be backed only by a pool consisting entirely of assets that met the underwriting standards. Second, sponsors would be required to repurchase any assets that were found not to have met the underwriting criteria at origination.

The agencies note the concern expressed by some commenters with respect to all three of these asset classes that, for the residential mortgage asset class and QRM, a significant portion of the existing market would qualify for an exemption from risk retention, whereas in proposing the underwriting standards for qualifying commercial loans, commercial real estate loans, and automobile loans, the agencies have proposed conservative underwriting criteria that will not capture an equivalent portion of the respective

markets. The agencies believe this is appropriate because the homogeneity in the securitized residential mortgage loan market is dissimilar to the securitization market for commercial loan or commercial real estate loan asset classes. Commercial loans and commercial real estate loans typically focus on a common set of borrower and collateral metrics, but they are individually underwritten and tailored to a specific borrower or property, and often certain terms developed in view not only of the borrower’s financial position but also the general business cycle, industry business cycle, and standards for appropriate leverage in that industry sub-sector. The agencies believe the additional complexity needed to create underwriting standards for every major type of business in every economic cycle would be so great that originators would almost certainly be dissuaded from attempting to implement them or attempting to stay abreast of the numerous regulatory revisions the agencies would be required to issue from time to time.

Moreover, the proposed underwriting standards establish clear requirements, which are necessary to enable originators, sponsors, and investors to be certain as to whether any particular loan meets the rule’s requirements for an exemption. For the agencies to expand the underwriting criteria in the fashion suggested by some commenters, the rules would need to accommodate numerous relative standards. The resulting uncertainty on behalf of market participants whether any particular loan was actually correctly designated on a particular point of those relative standards to qualify for an exemption would be expected to eliminate the market’s willingness to rely on the exemption.

While there may be more homogeneity in the securitized automobile loan class, the agencies are concerned that attempting to accommodate a significantly large share of the current automobile loan securitization market would require weakening the underwriting standards to the point where the agencies are skeptical that they would consistently reflect loans of a low credit risk. For example, the agencies note that current automobile lending often involves no or small down payments, financing in excess of the value of the automobile (which is itself a quickly depreciating asset) to accommodate taxes and fees, and a credit score in lieu of an analysis of the borrower’s ability to repay. These concerns as to credit quality are evidenced by the high levels of credit support automobile securitization

sponsors build into their ABS, even for so-called “prime” automobile loans. Moreover, securitizers from the automobile sector explicitly disavowed any interest in using any underwriting-based exemptive approach unless the agencies incorporated the industry’s current model, which relies almost exclusively on matrices of credit scores (like FICO) and LTV. As is discussed in the agencies’ original proposal, the agencies are not persuaded that it would be appropriate for the underwriting-based exemptions under the rule to incorporate a credit score metric.

#### **Request for Comment**

78(a). In light of the significant expansion of the proposed definition of QRM, should the agencies similarly significantly expand the type of loans that would meet the qualifying commercial, commercial real estate and automobile loan exemptions? 78(b). If so, please provide sufficient detailed data regarding loan underwriting criteria for each type of loan.

#### **A. Qualifying Commercial Loans**

The original proposal included definitions and underwriting standards for qualifying commercial loans (QCL), that, when securitized in a pool of solely QCLs, would have been exempt from the risk retention requirements. The proposed definition of commercial loan generally would have included any business loan that did not fit the definition of a commercial real estate loan or 1–4 family residential real estate loan.

The proposed criteria for a QCL included reviewing two years of past data; forecasting two years of future data; a total liabilities ratio less than or equal to 50 percent; a leverage ratio of less than or equal to 3.0 percent; a debt service coverage ratio of greater than or equal to 1.5 percent; a straight-line amortizing payment; fixed interest rates; a maximum five-year, fully amortizing loan term; and representations and warranties against the borrower taking on additional debt. Additional standards were proposed for QCLs that are backed by collateral, including lien perfection and collateral inspection.

Commenters generally asserted the proposed criteria were too strict in one or more areas. These commenters proposed a general loosening of the QCL standards to incorporate more loans, and suggested the agencies develop underwriting standards that would encompass 20 to 30 percent of loans currently issued. One commenter asserted that if the criteria were not loosened, the small chance a loan might qualify as a QCL would not incentivize

<sup>123</sup> Pursuant to section 15G, only the Federal banking agencies are proposing the underwriting definitions in § \_\_.14 (except the asset class definitions of automobile loan, commercial loan, and commercial real estate loan, which are being proposed by the Federal banking agencies and the Commission), and the exemption and underwriting standards in §§ \_\_.15 through \_\_.18 of the proposed rules.

lenders to go through all the initial tests and perform burdensome monitoring after origination.

Comments on the specific underwriting criteria included an observation that some commercial loans are offered with 15- or 20-year terms, with adjustable interest rates that reset every five years, and that such loans should qualify for the exemption. Another commenter suggested allowing second lien loans to qualify if they met all other underwriting criteria. A third commenter suggested requiring qualifying appraisals for all tangible or intangible assets collateralizing a qualified commercial loan.

In developing the underwriting standards for the original proposal, the agencies intended for the standards to be reflective of very high-quality loans because the loans would be completely exempt from risk retention. The agencies have carefully considered the comments on the original proposal, and generally believe that the high standards proposed are appropriate for an exemption from risk retention for commercial loans. In addition, while commercial loans do exist with longer terms, the agencies do not believe such long-term commercial loans are necessarily as safe as shorter-term commercial loans, as longer loans involve more uncertainty about continued repayment ability. Accordingly, the agencies are proposing underwriting standards for QCLs similar to those in the original proposal. However, as discussed below, the agencies are proposing to allow blended pools to facilitate the origination and securitization of QCLs.

The agencies are proposing some modifications to the standards in the original proposal for QCLs. Under the proposal, junior liens may collateralize a QCL. However, if the purpose of the commercial loan is to finance the acquisition of tangible or intangible property, or to refinance such a loan, the lender would be required to obtain a first lien on the property for the loan to qualify as a QCL. While a commercial lender should consider the appropriate value of the collateral to the extent it is a factor in the repayment of the obligation, the agencies are declining to propose a requirement of a qualifying appraisal, so as not to increase the burden associated with underwriting a QCL.

#### Request for Comment

79(a). Are the revisions to the qualifying commercial loan exemption appropriate? 79(b). Should other revisions be made?

80(a). In evaluating the amortization term for qualifying commercial loans, is full amortization appropriate? 80(b). If not, what would be an appropriate amortization period or amount for high-quality commercial loans?

#### *B. Qualifying Commercial Real Estate Loans*

The original proposal included underwriting standards for CRE loans that would have been exempt from risk retention (qualifying CRE loans, or QCRE loans). The proposed standards focused predominately on the following criteria: The borrower's capacity to repay the loan; the value of, and the originator's security interest in, the collateral; the loan-to-value (LTV) ratio; and, whether the loan documentation includes the appropriate covenants to protect the value of the collateral.

Commenters generally supported the exemption from risk retention in the original proposal for QCRE loans. However, many questioned whether the QCRE loan exemption would be practicable, due to the stringency of the qualifying criteria proposed by the agencies. Some commenters asserted that less than 0.4 percent of conduit loans that have been securitized since the beginning of the CMBS market would meet the criteria. Most commenters requested that the agencies loosen the QCRE loan criteria to allow more loans to qualify for the exemption.

In the original proposal, a commercial real estate (CRE) loan would have been defined as any loan secured by a property of five or more residential units or by non-residential real property, where the primary source of repayment would come from the proceeds of sale or refinancing of the property or rental income from entities not affiliated with the borrower. In addition, the definition would have specifically excluded land loans and loans to real estate investment trusts (REITs).

Three main concerns were expressed by commenters with respect to the definition of CRE loans in the original proposal. First, some commenters questioned why CRE loans must be repaid from funds that do not include rental income from an affiliate of the borrower. These commenters said that in numerous commercial settings, particularly hotels and hospitals, entities often rent commercial properties from affiliated borrowers, and those rental proceeds are used to repay the underlying loans. These commenters strongly encouraged the agencies to remove the affiliate rent prohibition.

Second, some commenters questioned the exclusion of certain land loans from

the definition of CRE in the original proposal. Specifically, these commenters stated that numerous CMBS securitizations include loans to owners of a fee interest in land that is ground leased to a third party who owns the improvements and whose ground lease payments are a source of income for debt service payments on the loan. These commenters suggested that the agencies clarify that the exclusion did not apply to such loans.

Third, many commenters criticized the agencies for excluding loans to REITs from the definition of CRE loans in the original proposal. These commenters asserted that mortgage loans on commercial properties where the borrower was a REIT are no riskier than similar loans where the borrower was a non-REIT partnership or corporation and that a significant portion of the CMBS market involves underlying loans to finance buildings owned by REITs. These commenters requested that the agencies delete the restriction against REITs, or in the alternative clarify that the prohibition only applies to loans to REITs that are not secured by mortgages on specific commercial real estate.

The agencies are proposing the CRE definition from the original proposal again, with some modifications to address the commenter concerns discussed above. Regarding affiliate rental income, the agencies were concerned when developing the original proposal that a parent company might lease a building to an affiliate and manipulate the rental income so that the loan on the building would meet the requirements for a qualifying CRE loan. However, the agencies did not intend to exclude the types of hotel loans mentioned by commenters from the CRE loan definition, because the agencies do not consider income from hotel guests to be derived from an affiliate. The agencies are therefore proposing to specify that "rental income" in the CRE loan definition would be any income derived from a party who is not an affiliate of the borrower, or who is an affiliate but the ultimate income stream for repayment comes from unaffiliated parties (for example, in a hotel, dormitory, nursing home, or similar property).

Regarding land loans, the agencies are concerned that weakening any restriction on land loans would allow for riskier QCRE loans, as separate parties could own the land and the building on the land and could make servicing and foreclosure on the loan more difficult. Therefore, the agencies are continuing to propose to exclude all land loans from the CRE loan definition.

Finally, in developing the original proposal, the agencies intended to not allow unsecured loans to REITs, or loans secured by general pools of REIT assets rather than by specific properties, to be qualifying CRE loans. However, the agencies did not intend to exclude otherwise valid CRE loans from the definition solely because the borrower was organized as a REIT structure. After reviewing the comments and the definition of CRE loan, the agencies have decided to remove the language excluding REITs in the proposed definition.

The agencies divided the underwriting criteria in the original proposal into four categories: Ability to repay, loan-to-value requirement, valuation of the collateral, and risk management and monitoring.

#### 1. Ability To Repay

The agencies proposed in the original proposal a number of criteria relating to the borrower's ability to repay in order for a loan to qualify as QCRE. The borrower would have been required to have a debt service coverage (DSC) ratio of at least 1.7, or at least 1.5 for certain residential properties or certain commercial properties with at least 80 percent triple-net leases.<sup>124</sup> The proposed standards also would have required reviewing two years of historical financial data and two years of prospective financial data of the borrower. The loan would have been required to have either a fixed interest rate or a floating rate that was effectively fixed under a related swap agreement. The loan document also would have had to prohibit any deferral of principal or interest payments and any interest reserve fund. The loan payment amount had to be based on straight-line amortization over the term of the loan not to exceed 20 years, with payments made at least monthly for at least 10 years of the loan's term.

Numerous commenters objected to the agencies' proposed DSC ratios as too conservative, and proposed eliminating the DSC ratio, lowering qualifying DSC ratios to a range between 1.15 and 1.40, or establishing criteria similar to those used by Fannie Mae or Freddie Mac to fund multifamily real estate loans.

Many commenters stated that, if the agencies retained the DSC ratios, they should remove the triple-net-lease requirement. Many of these commenters stated that full service gross leases,

rather than triple-net leases, are used more often in the industry.<sup>125</sup>

Some commenters supported replacing the proposed requirement to examine two years of past and future borrower data with one to gather two or three years of historical financial data on the property, not attempt to forecast two years of future data and to allow new properties with no operating history to qualify. Many commenters supported the requirement for fixed interest rate loans for QCRE. However, some commenters suggested expanding the types of derivatives allowed to convert a floating rate into a fixed rate. Many commenters also supported the restrictions on deferrals of principal and interest and on interest reserve funds. However, a few commenters supported allowing some interest-only loans or interest-only periods, in connection with a lower LTV ratio (such as 50 percent).

Many commenters objected to the minimum length and amortization of QCRE loans. These commenters said that 3, 5, and 7-year CRE loans have become common in the industry, and so a minimum 10-year term would disqualify numerous loans. In addition, most commenters supported a longer amortization period for QCRE loans, such as 25 or 30 years. Some commenters also proposed replacing the amortization requirement with a maximum LTV at maturity (based on value at origination) that is lower than LTV at origination, which would require some amortization of the loan principal.

After considering the comments on the underwriting criteria for QCREs, the agencies are proposing criteria similar to that of the original proposal, with some modifications. Based on a review of underwriting standards and performance data for multifamily loans purchased by the Enterprises, the agencies are proposing to require a 1.25 DSCR for multifamily properties to be QCRE.<sup>126</sup> After review of the comments and the Federal banking agencies' historical standards for conservative CRE lending,<sup>127</sup> for loans other than qualifying multifamily property loans, the agencies are proposing to retain the

1.5 DSCR for leased QCRE loans and 1.7 for all other QCREs. As discussed below, removing the criterion on triple-net leases should allow more loans to qualify for an exemption with the 1.5 DSCR requirement, rather than the 1.7 DSCR requirement that would have applied under the original proposal.

The agencies considered the comments requesting a debt yield requirement, but have decided not to include that in the proposed rule. Historically, DSCR has been, and continues to be, widely used in CRE lending. Debt yield is a relatively recent concept that was not tracked in many historic CMBS deals, which makes it difficult for the agencies to calculate historical performance and determine what the appropriate level should be for a CRE loan exempt from risk retention. The agencies recognize that the DSCR is not a perfect measure, particularly in low interest rate environments. However, the agencies also do not want to introduce a relatively new methodology into the CRE market without long-term data to support the appropriateness of that measure.

Based on the agencies' further review of applicable data, it appears that a significant number of leases are written as full-service gross leases, not triple-net leases, and that difference should not preclude treatment as a QCRE loan. Since the proposed underwriting requirements are based on net operating income (NOI), whether a tenant has a triple-net lease or full-service gross lease should not significantly affect the borrower's NOI.

The agencies propose to continue to require that the analysis of whether a loan is a QCRE be made with respect to the borrower and not be limited to the property only. While the agencies observe that some CRE loans are non-recourse, others include guarantees by the borrowers. The agencies are concerned that focusing solely on the property could be problematic in cases where the borrower may have other outstanding commitments that may lead the borrower to siphon cash flow from the underwritten property to service the other commitments. By analyzing the borrower's position, and not solely the property's income, the underwriting should better address this risk. The agencies believe that two years of historical data collection and two years of forecasted data are appropriate, and that properties with less than two years of operating history should not qualify as QCRE loans. The longer a property has been operating, particularly after the first few years of operation, the better the originator can assess the stability of cash flows from the property going

<sup>124</sup> The original proposal defined a triple-net lease as one in which the lessee, not the lessor, is obligated to pay for taxes, insurance, and maintenance on the leased property.

<sup>125</sup> In a full-service gross lease, the lessor pays for taxes, maintenance, and insurance (presumably covering the additional costs by charging a higher rental amount to the lessee than under a triple-net lease).

<sup>126</sup> The agencies reviewed origination volume and performance history, as tracked by the TREPP CMBS database, for multifamily loans securitized from 2000 through 2011.

<sup>127</sup> These standards include the "Interagency Guidelines for Real Estate Lending," 12 CFR part 34, subpart D, Appendix A (OCC); 12 CFR part 208, subpart C, Appendix A (FRB); 12 CFR part 365, Appendix A (FDIC).

forward. New properties present significant additional risks and loans on those properties generally should not be exempt from risk retention.

The proposal would continue to require that the interest rate on a QCRE loan be fixed or fully convertible into a fixed rate using a derivative product. The agencies are not proposing to allow other types of derivatives because of concerns about transparency with other types of derivative products, including mixed derivative products. For example, if the agencies allowed a derivative that established an interest rate cap, it may not be clear to investors whether a loan was underwritten using the current market rate or the maximum rate allowed under the interest rate cap. The agencies are also proposing to retain from the original proposal the requirement not to include interest-only loans or interest-only periods in QCRE loans. The agencies believe that interest-only loans or interest-only periods are associated with higher credit risk. If a borrower is not required to make any form of principal payment, even with a 25-year amortization period, it raises questions as to the riskiness of the loan, and would be inappropriate for qualifying CRE loan treatment.

The agencies are proposing some modifications from the original proposal to the standards for QCRE loan terms. The agencies recognize that there are CRE loans with amortization periods in excess of 20 years. Allowing a longer amortization period reduces the amount of principal paid on the CRE loan before maturity, which can increase risks related to having to refinance a larger principal amount than would be the case for a CRE loan with a shorter amortization period. Because the agencies believe exemptions from risk retention should be available only for the most prudently underwritten CRE loans, the agencies believe it is appropriate to consider the risks of an overly long amortization period for a QCRE. In balancing those risks with commenters' concerns, the agencies are proposing to increase the amortization period to 30 years for multifamily residential QCRE loans and to 25 years for all other QCRE loans.

The agencies are continuing to propose to set a 10-year minimum maturity for QCRE loans. The agencies are concerned that introducing terms shorter than 10 years, such as three or five years, may create improper underwriting incentives and not create the low-risk CRE loans intended to qualify for the exemption. When making a short-term CRE loan, an originator may focus only on a short timeframe in evaluating the stability of the CRE

underlying the loan in an industry that might be at or near the peak of its business cycle. In contrast, a 10-year maturity CRE loan allows for underwriting through a longer business cycle, including downturns that may not be appropriately captured when underwriting to a three-year time horizon.

## 2. Loan-to-Value Requirement

The agencies proposed in the original proposal that the combined loan-to-value ratio (CLTV) for QCRE loans be less than or equal to 65 percent (or 60 percent for certain valuation assumptions).

Many commenters recognized the value in setting LTV ratio requirements in CRE underwriting. While some commenters supported the agencies' proposed ratios, others did not. Some commenters suggested that higher LTV ratios should be allowed in the QCRE standards, generally between 65 percent and 80 percent, particularly for properties in stable locations with strong historical financial performance. One commenter suggested lower LTVs for properties that may be riskier. Numerous commenters suggested taking a different approach by setting maximum LTVs at origination and maturity, with a maturity LTV aimed at controlling the risk that the borrower would not be able to refinance. A number of commenters also objected to setting the CLTV ratio at 65 percent. These commenters said that many commercial properties involve some form of subordinate financing. Some commenters proposed eliminating the CLTV ratio entirely and thus allow borrowers to use non-collateralized debt to finance the properties. Other commenters proposed establishing a higher CLTV ratio (such as 80 percent) and allow for non-QCRE second liens on the properties.

The agencies have considered the comments on LTV for QCRE loans and are proposing to modify this aspect of QCRE underwriting standards from the standard in the original proposal by proposing to establish a maximum LTV ratio of 65 percent for QCRE loans. The agencies also are proposing to allow up to a 70 percent CLTV for QCRE loans. The more equity a borrower has in a CRE project, generally the lower the lender or investor's exposure to credit risk. Overreliance on excessive mezzanine financing instead of equity financing for a CRE property can significantly reduce the cash flow available to the property, as investors in mezzanine finance often require high rates of return to offset the increased risk of their subordinate position. In

proposing underwriting criteria for the safest CRE loans that would be exempt from risk retention requirements, the agencies believe a 70 percent CLTV cap is appropriate, which would require the borrower to have at least 30 percent equity in the project to help protect securitization investors against losses from declining property values and potential defaults on the CRE loans.

The agencies are also proposing to retain the requirement that the maximum CLTV ratio be lowered by 5 percent if the CRE property was appraised with a low capitalization (cap) rate. Generally, assuming a low cap rate will inflate the appraised value of the CRE property and thus increase the amount that can be borrowed given a fixed LTV or CLTV. Therefore, such a loan would have a maximum 60 percent LTV and 65 percent CLTV. In addition, to address the commenters' concerns about high cap rates, the agencies are proposing that the cap rates used in CRE appraisals be disclosed to investors in securitizations that own CRE loans on those properties.

The agencies are declining to propose requirements for LTVs or CLTVs at both origination and maturity. The agencies are concerned that introducing the concept of front-end and back-end LTV ratios, rather than using straight-line amortization, would allow borrowers to make nominal principal payments in early years and back-load a large principal payment toward maturity. The effect would be to significantly increase the riskiness of the CRE loan at maturity, rather than if the loan had been underwritten to provide straight-line amortization throughout its life. Therefore, the agencies have decided not to propose to include this amortization approach in the revised proposal and instead continue to propose the straight-line amortization requirement.

## 3. Collateral Valuation

In the original proposal, the agencies proposed to require an appraisal and environmental risk assessment for every property serving as collateral for a QCRE. Commenters strongly supported both the valuation appraisal and environmental risk assessment for all QCRE properties. Many commenters indicated this is already standard industry practice. The agencies are continuing to include this requirement in the proposed rule.

## 4. Risk Management and Monitoring

The original proposal would have required that a QCRE loan agreement require borrowers to supply certain financial information to the sponsor and

servicer. In addition, the agreement would have had to require lenders to take a first lien in the property and restrict the ability to pledge the property as collateral for other loans.

Many commenters supported the risk management provisions for supplying financial information. Some commenters requested clarification that such information should relate to the property securing the QCRE loan rather than financial information on the borrower. These commenters said that most CRE loans are non-recourse, making the property the sole source of repayment and thus its financial condition as far more important than the borrower's condition.

Commenters supported the first-lien requirement. In addition, some commenters requested removing the restriction on granting second liens on the property to allow borrowers access to subordinate financing. These commenters suggested establishing a CLTV to restrict the total debt on the property. Finally, some commenters supported the requirement that a borrower retain insurance on the property up to the property value, while other commenters supported a requirement to have insurance only for the replacement cost of the property.

The agencies are proposing to modify the requirement in the original proposal that the borrower provide information to the originator (or any subsequent holder) and the servicer, including financial statements of the borrower, on an ongoing basis. The agencies believe that the servicer would be in the best position to collect, store, and disseminate the required information, and could make that information available to holders of the CRE loans. Therefore, to reduce burden on the borrowers, the agencies are not proposing a requirement to provide this information directly to the originator or any subsequent holder.

The agencies are retaining the proposed requirement from the original proposal that the lender obtain a first lien on the financed property. The agencies note that most CRE loan agreements allow the lender to receive additional security by taking an assignment of leases or other occupancy agreements on the CRE property, and the right to enforce those leases in case of a breach by the borrower. In addition, the agencies observe that standard CRE loan agreements also often include a first lien on all interests the borrower has in or arising out of the property used to operate the building (for example, furniture in a hotel). The agencies believe these practices enhance prudent lending and therefore would be

appropriate to include this blanket lien requirement on most types of borrower property to support a QCRE loan. There would be an exception for purchase-money security interests in machinery, equipment, or other borrower personal property.

The agencies continue to believe that as long as the machinery and equipment or other personal property subject to a purchase-money security interest is also pledged as additional collateral for the QCRE loan, it would be appropriate to allow such other liens. In addition, the proposal would restrict junior liens on the underlying real property and leases, rents, occupancy, franchise and license agreements unless a total CLTV ratio was satisfied.

The agencies are continuing to propose a requirement that the borrower maintain insurance against loss on the CRE property at least up to the amount of the CRE loan. The agencies believe that the insurance requirement should serve to protect the interests of investors and the qualifying CRE loan in the event of damage to the property. Insuring only the replacement cost would not sufficiently protect investors, who may be exposed to loss on the CRE loan from significantly diminished cash flows during the period when a damaged CRE property is being repaired or rebuilt.

Although commenters were concerned that few CMBS issuers will be able to use this exemption due to the conservative QCRE criteria, the agencies are keeping many of the same underwriting characteristics for the reasons discussed at the beginning of Part V of this Supplementary Information.

#### Request for Comment

81(a). Is including these requirements in the QCRE exemption appropriate?

81(b). Why or why not?

82. The agencies request comment on the proposed underwriting standards, including the proposed definitions and the documentation requirements

#### C. Qualifying Automobile Loans

The original proposal included underwriting standards for automobile loans that would be exempt from risk retention (qualifying automobile loans, or QALs). Some commenters proposed including an additional QAL-lite option, which would incorporate less stringent underwriting standards but be subject to a 2.5 percent risk retention amount based on a matrix of borrower FICO scores, loan terms and LTVs of up to 135 percent. The agencies are declining to propose a QAL-lite standard to avoid imposing a regulatory burden of monitoring multiple underwriting

standards for this asset class. However, as discussed below, the agencies are proposing to allow blended pools of QALs and non-QALs, which should help address commenters' concerns. The definition of automobile loan in the original proposal generally would have included only first-lien loans on light passenger vehicles employed for personal use. It specifically would have excluded loans for vehicles for business use, medium or heavy vehicles (such as commercial trucks and vans), lease financing, fleet sales, and recreational vehicles such as motorcycles. The underwriting standards from the original proposal focused predominately on the borrower's credit history and a down payment of 20 percent.

While some commenters supported the definition of automobile loan, others stated it was too narrow. These commenters suggested expanding the definition to include motorcycles because they may not be used solely as recreational vehicles. In addition, commenters suggested allowing vehicles purchased by individuals for business use, as it may be impossible to monitor the use of a vehicle after sale. Commenters representing sponsors also supported allowing automobile leases to qualify as QALs, with corresponding technical changes. In addition, a few commenters supported expanding the definition to include fleet purchases or fleet leasing, on the basis that these leases or sales are generally with corporations or government entities with strong repayment histories.

The agencies have considered these comments and are proposing a definition of automobile loans for QAL underwriting standards that is substantially similar to the definition in the original proposal. The agencies believe it continues to be appropriate to restrict the definition of automobile loan to not include loans on vehicles that are more frequently used for recreational purposes, such as motorcycles or other recreational vehicles. The agencies also do not believe it would be appropriate to expand the exemption to include vehicles used for business purposes, as the risks and underwriting of such loans differ from those of vehicles used for personal transportation. For example, a car or truck used in a business may endure significantly more wear and depreciate much faster than a vehicle used only for normal household use.

The agencies are not proposing to expand the definition to include automobile leases. While the difference between an automobile purchase and a lease may not be significant to a customer, leases represent a different set of risks to securitization investors. As

one example, at the end of a lease, a customer has the right to return the automobile, and the securitization may suffer a loss if the resale price of that automobile is less than expected. In an automobile loan securitization, the customer owns the vehicle at the end of the loan term, and cannot return it to the dealer or the securitization trust.

In the original proposal, the agencies proposed conservative underwriting standards, including a 36 percent DTI requirement, a 20 percent down payment requirement, and credit history standards. Generally, commenters opposed the QAL criteria as too conservative, and asserted that less than 1 percent of automobile loans would qualify. Even those commenters who otherwise supported the conservative QAL underwriting suggested some revisions would be necessary to bring them in line with current market standards. Automobile sponsor commenters acknowledged that the agencies' proposed terms would be consistent with very low credit risk, or "super-prime" automobile loans, but believed that the standard should be set at the "prime" level, consistent with low credit risk. In addition, commenters criticized the agencies for applying to QALs underwriting criteria similar to those they applied to QRMs and unsecured lending. Automobile sponsor commenters stated that automobile loans are significantly different from mortgage loans, as they are smaller and shorter in duration and have readily-salable collateral. Investor commenters supported a standard that was above "prime," but indicated that they could support a standard that included loans that did not meet the very conservative "super-prime" QAL criteria proposed by the agencies.

Although the agencies have taken into consideration the comments that these standards do not reflect current underwriting practices, the agencies generally do not believe it would be appropriate to include a standard based on FICO scores in the QAL underwriting standards. Further, as discussed in Part III.B.1 of this **SUPPLEMENTARY INFORMATION**, the agencies have revised the risk retention requirements to address some of the concerns about risk retention for automobile securitizations to better enable sponsors of automobile securitizations to comply with the risk retention requirements in a manner consistent with their existing and current practices.

#### 1. Ability To Repay

The agencies proposed in the original proposal for QALs a debt-to-income (DTI) ratio not in excess of 36 percent

of a borrower's monthly gross income. Originators would have been required to verify a borrower's income and debt payments using standard methods. Many commenters opposed including a DTI ratio as part of the underwriting criteria for QALs. These commenters believed that the significant additional burden of collecting documents to verify debts and income would far outweigh any benefit, and could have the unanticipated result of only applying the burden to the most creditworthy borrowers whose loans could potentially qualify for QAL status. A few commenters asserted that it was nearly impossible to check information such as required alimony or child support. In addition, these commenters were concerned about potentially changing DTIs between origination and securitization. Commenters also asserted that in practice, only the most marginal of automobile lending used income or employment verification. Some automobile sponsor commenters said the industry does not use DTIs in prime automobile origination because they do not believe it is predictive of default, and that the agencies should instead adopt the established industry practice of setting FICO score thresholds as an indicator of ability to repay.

The agencies have considered these comments, but continue to believe that assessing a borrower's ability to repay is important in setting underwriting criteria to identify automobile loans that would not be subject to risk retention. DTI is a meaningful figure in calculating a customer's ability to repay a loan, and therefore the agencies continue to propose the same DTI requirement as in the original proposal. As discussed in more detail, the agencies also observe that they generally do not believe it would be appropriate to include a standard based on FICO scores in the QAL underwriting standards, because it would tie a regulatory requirement to third party, private industry models.

#### 2. Loan Terms

Under the original proposal, QAL interest rates and payments would have had to be fixed over the term of the loan. In addition, the loan would have had to be amortized on a straight-line basis over the term. Loans could not have exceeded five years (60 months); for used car loans, the maximum term would have been one year shorter for every year difference between the current year and the used car's model year. Furthermore, the terms would have required that the originator, or agent, to retain physical possession of the title until full repayment.

While commenters supported the proposed requirements for fixed interest rates and fixed monthly payments, most commenters opposed one or more of the additional proposed QAL loan terms. The straight-line amortization requirement was the most problematic issue for commenters. Commenters asserted that automobile loans are generally amortized using the simple interest method with fixed, level payments and that the simple interest method provides that earlier payments would amortize less principal, and later payments would amortize more principal, rather than a straight-line amortization as proposed by the agencies.

In addition, many commenters were concerned that numerous states require the vehicle's owner (borrower) to retain the physical title, and that some states are moving to issue electronic titles that cannot have a physical holder. These commenters suggested revising the proposed rule to either remove the requirement, or condition it on compliance with applicable state law.

Many commenters also opposed the 60-month maximum loan term, stating that current industry standards allow for 72-month loans. Some commenters believed that the used-car restrictions were too harsh, citing the "certified pre-owned" programs available for most used cars and longer car lives in general. These commenters suggested either removing the used car term restriction, or else loosening the standard to exclude from QALs used cars over six years old, rather than over five years old, as proposed by the agencies. Commenters also suggested a technical change to require the first payment within 45 days of the contract date rather than on the closing date.

The agencies have considered these comments and are proposing the QAL standards with some modifications to the original proposal's standards. Instead of a straight-line amortization requirement, the agencies are proposing a requirement that borrowers make level monthly payments that fully amortize the automobile loan over its term. Second, the agencies are replacing the requirement in the original proposal that the originator retain physical title with a proposed requirement that the lender comply with appropriate state law for recording a lien on the title. Third, the agencies are proposing to expand the maximum allowable loan term for QALs to the lesser of six years (72 months) or 10 years less the vehicle's age (current model year less vehicle's model year). Due to this modification, there would no longer be a distinction between new vehicles and

used vehicles for the QAL definition. Finally, the agencies are proposing that payment timing be based on the contract date.

### 3. Reviewing Credit History

In the original proposal, an originator would have been required to verify, within 30 days of originating a QAL, that the borrower was not 30 days or more past due; was not more than 60 days past due over the past two years; and was not a judgment debtor or in bankruptcy in the past three years. The agencies also proposed a safe harbor requiring the originator to review the borrower's credit reports from two separate agencies, both showing the borrower complies with the past-due standards. Also, the agencies proposed a requirement that all QALs be current at the closing of the securitization.

Commenters were concerned that these criteria in the original proposal were so strict as to require them to follow the safe harbor. They indicated substantial risk that they may make a QAL, but then within 30 days after the loan, review the credit history and note a single 30-day late payment, thus disqualifying the loan for QAL status. To avoid this outcome, commenters (including some investors) suggested removing the 30-day past due criteria, also citing their belief that many otherwise creditworthy borrowers could have inadvertently missed a single payment within that timeframe. Some sponsor commenters favored elimination of the credit disqualification standards entirely in favor of a FICO cutoff; some investor commenters acknowledged the established role of FICO but favored maintaining most of the disqualification standards in addition to FICO.

On the assumption that all originators would rely on the credit report safe harbor, commenters asserted that the requirement to obtain reports from two separate credit reporting agencies unnecessarily increased costs. These commenters stated that so much information is shared among the credit reporting agencies, that two credit reports are no more predictive than one report of the creditworthiness of a borrower. The commenters also stated that this report should be obtained within 30 days of the contract date, rather than within 90 days as proposed.

Some commenters also opposed the requirement in the original proposal that borrowers remain current when the securitization closes. These commenters stated that securitizations have a "cutoff" date before the closing date, when all the QALs would be pooled and information verified. It would be

possible for a loan to become late between the cutoff and closing date without the sponsor knowing until after closing. Instead, sponsors suggested replacing the proposed rule requirement with a representation made by the sponsor that no loan in the securitized pool is more than 30 days past due at cutoff, with the securitizer being required to verify that representation for each loan no more than 62 days from the securitization's closing date.

The agencies believe that a QAL should meet conservative underwriting criteria, including that the borrower not be more than 30 days late. However, to reduce the burden associated with reviewing credit reports for those delinquencies, the agencies are proposing to require only one credit report rather than two, and that the report be reviewed within 30 days of the contract date, as requested by commenters. The agencies are proposing the same requirements as in the original proposal for verification that the automobile loan is current when it is securitized. The agencies believe a securitization exempt from risk retention should contain only current automobile loans.

Finally, the agencies are not proposing requirements that would rely on proprietary credit scoring systems or underwriting systems. The agencies recognize that much of the current automobile lending industry relies heavily or solely on a FICO score to approve automobile loans. However, the agencies do not believe that a credit score alone is sufficient underwriting for a conservative automobile loan with a low risk of default. Furthermore, the agencies do not believe it is appropriate to establish regulatory requirements that use a specific credit scoring product from a private company, especially one not subject to any government oversight or investor review of its scoring model. The agencies believe that the risks to investors of trusting in such proprietary systems and models weighs against this alternative, and does not provide the transparency of the bright line underwriting standards proposed by the agencies.

### 4. Loan-to-Value

In the original proposal, the agencies proposed to require automobile loan borrowers to pay 100 percent of the taxes, title costs, and fees, in addition to 20 percent of the net purchase price (gross price less manufacturer and dealer discounts) of the car. For used cars, the purchase price would have been the lesser of the actual purchase price or a value from a national pricing service.

Most commenters opposed the down payment and loan-to-value requirements. These commenters cited current automobile industry practices where up to 100 percent of the purchase price of the car is financed, along with taxes, title costs, dealer fees, accessories, and warranties. Some commenters proposed eliminating the LTV entirely, or replacing it with a less conservative standard.

The agencies have considered the comments and the underwriting standards and have concluded that a lower down payment could be required without a significant decline in the credit quality of a QAL. Therefore, the agencies are proposing a down payment of at least 10 percent of the purchase price of the vehicle, plus 100 percent of all taxes, fees, and extended warranties. The agencies do not believe that a collateralized loan with an LTV over 90 percent would be low-risk, and that a customer should put some of the customer's own cash into the deal to reduce risks for strategic default and in-cent repayment of the loan. The agencies would also define purchase price consistently across new and used vehicles to equal the price negotiated with the dealer less any manufacturer rebates.

### Request for Comment

83(a). Are the revisions to the qualifying automobile loan exemption appropriate? 83(b). If not, how can they be modified to more appropriately reflect industry standards?

84. Are all the proposed underwriting criteria appropriate?

### D. Qualifying Asset Exemption

As discussed above, numerous industry and sponsor commenters on the original proposal for reduced risk retention requirements for commercial, CRE, and automobile loans asserted that the requirement that all assets in a collateral pool must meet the proposed underwriting standards (qualifying assets) to exempt the securitization transaction from risk retention was too stringent. These commenters stated that requiring every asset in a collateral pool to meet the proposed conservative underwriting requirements would make it difficult to obtain a large enough pool of qualifying assets to issue a securitization in a timely manner, and therefore some originators would not underwrite to the qualifying asset standards. These commenters suggested that the agencies allow a proportional reduction in required risk retention for those assets in a collateral pool that met the proposed underwriting standards. For example, if a pool contained 20

percent automobile loans that are qualifying assets and 80 percent of other automobile loans, only 80 percent of the pool would be subject a risk retention requirement.

Commenters representing investors in securitization transactions generally opposed blended pools of qualifying assets and other assets. These investors stated that blending could allow sponsors too much latitude to mix high-quality qualifying assets, which may pay down first, with low-quality non-qualifying assets, which would create significant risk of credit loss for investors over the course of the transaction.

The agencies have carefully considered the comments and are proposing to apply a 0 percent risk retention requirement to qualifying assets, where both qualifying assets and non-qualifying assets secure an asset-backed security.<sup>128</sup> Any non-qualifying assets that secure an asset-backed security would be subject to the full risk retention requirements in the proposed rule, including hedging and transfer restrictions.

The agencies believe that applying a 0 percent risk retention requirement to assets that meet the proposed underwriting standards would be appropriate given the very high credit quality of such assets. In addition, allowing both qualifying and non-qualifying assets to secure an asset-backed security should promote liquidity in the relevant securitization markets without harming the goals of risk retention requirement. The agencies understand that a lender may not be able to originate, or a sponsor aggregate, an entire pool of qualifying assets within a reasonable amount of time to promote efficient securitization. The

agencies believe that the proposal to apply a 0 percent risk retention requirement to qualifying assets would likely enhance the liquidity of loans underwritten to the qualifying asset underwriting standards, thereby encouraging originators to underwrite more qualifying assets of high credit quality.

The agencies recognize that section 15G is generally structured in contemplation of pool-level exemptions, and that investors, whom the statute is designed to protect, expressed some preference during the agencies' initial proposal for a pool-level approach. The agencies believe the structure of the proposal could offset these concerns. The agencies are proposing to reduce the sponsor's 5 percent risk retention requirement by the ratio of the combined unpaid principal balance (UPB) of qualified loans bears to the total UPB of the loans in the pool.<sup>129</sup> The agencies believe this method is more appropriate than a system based on the absolute number of qualifying loans in the pool, as a sponsor could create a pool with a large number of small value qualifying loans combined with a few low-quality loans with large principal balances. The agencies have also considered an "average balance" approach as an alternative, but are concerned that it could be used to reduce overall risk retention on pools of loans with disparate principal balances skewed towards a few large non-qualified loans.

To address transparency concerns, the agencies are proposing that sponsors of asset-backed securities that are secured by both qualifying and non-qualifying assets disclose to investors, their primary Federal regulator (as appropriate), and the Commission the manner in which the sponsor determined the aggregate risk retention requirement for the pool after including qualifying assets with 0 percent risk retention, a description of the qualified and nonqualified assets groups, and any material differences between them with respect to the composition of each group's loan balances, loan terms, interest rates, borrower credit information, and characteristics of any loan collateral.

The agencies would not make blended pool treatment available for securitizations of loans from different asset classes (*i.e.*, automobile and commercial) that secure the same asset-

backed security. The agencies believe that blending across asset classes would significantly reduce transparency to investors. In addition, the agencies are also considering imposing a limit on the amount of qualifying assets a sponsor could include in any one securitization involving blended pools through a 2.5 percent risk retention minimum for any securitization transaction, but the agencies are also considering the possibility of raising or lowering that limit by 1 or more percent. The agencies recognize that it might be useful for sponsors acting on a transparent basis to attempt to allay moderate investor reservations about some assets in a pool by including other high-quality assets. However, one consistent theme in the agencies consideration of risk retention has been to require sponsors to hold a meaningful exposure to all assets they securitize that are subject to the full risk retention requirement. The agencies are concerned that providing sponsors unlimited flexibility with respect to mixing qualifying and non-qualifying collateral pools could create opportunities for practices that would be inconsistent with this over-arching principle.

The agencies also acknowledge investor concerns about mixing qualifying and non-qualifying assets, as noted above. For example, some investors commenting on the original proposal expressed concern that sponsors might be able to manipulate such combinations to achieve advantages that are not easily discernible to investors, such as mixing high-quality shorter-term assets with lower-quality longer-term assets. In this regard, the agencies observe the Commission's current proposal on loan level disclosures to investors in asset-backed securities represents a mechanism by which investors would obtain a more detailed view of loans in the pool than they sometimes did in prior markets.<sup>130</sup> However the agencies remain concerned about potential abuses of this aspect of the proposed rule and seek comment on how to address this issue beyond the disclosure requirements already included in the proposed rule. For example, an additional requirement that qualifying assets and non-qualifying assets in the same collateral pool do not have greater than a one year difference in maturity might alleviate some investor concerns.

<sup>128</sup> Under 15 U.S.C. 780-11(c)(1)(B)(ii), the agencies may require a sponsor to retain less than 5 percent of the credit risk for an asset that securitizes an asset-backed security, if the asset meets the underwriting standards established by the agencies under 15 U.S.C. 780-11(c)(2)(B). Accordingly, the agencies are proposing to require 0 percent risk retention with respect to any asset securitizing an asset-backed security that meet the proposed underwriting standards for automobile loans, commercial loans, or commercial real estate loans. See 15 U.S.C. 780-11(c)(1)(B)(ii). The agencies also believe that exempting qualifying assets from risk retention would be consistent with 15 U.S.C. 780-11(e) and the purposes of the statute. The agencies believe the exemption could, in a direct manner, help ensure high-quality underwriting standards for assets that are available for securitization, and create additional incentives under the risk retention rules for these high-quality assets to be originated in the market. The agencies further believe such an exemption would encourage appropriate risk management practices by securitization sponsors and asset originators, by establishing rigorous underwriting standards for the exempt assets and providing additional incentives for these standards to take hold in the marketplace.

<sup>129</sup> If a \$100 million pool of commercial mortgages included a sum total of \$20 million of qualified commercial mortgages (by UPB), the ratio would be 1/5, and the sponsor could reduce its 5 percent risk retention requirement by one-fifth, for a retention holding requirement of 4 percent.

<sup>130</sup> See *Asset-Backed Securities*, Release Nos. 33-9117, 34-61858, 75 FR 23328 (May 3, 2010), and *Re-proposal of Shelf Eligibility Conditions for Asset-Backed Securities and Other Additional Requests for Comment*, Release Nos. 33-9244, 34-64968, 76 FR 47948 (August 5, 2011).

Additional disclosure requirements might also alleviate this concern.

In addition, the agencies are proposing (consistent with the original proposal) that securitization transactions that are collateralized solely by qualifying assets (of the same asset class) and servicing assets would be exempt from the risk retention requirements of the proposed rule.

#### Request for Comment

85. Commenters on the QRM approach contained in the agencies' original proposal requested that the agencies permit blended pools for RMBS. The agencies invite comment on whether and, if so how, such an approach may be constructed where the underlying assets are residential mortgages, given the provisions of paragraph (c)(1)(B)(i)(II) and the exemption authority in paragraph (c)(2)(B), (e)(1) and (e)(2) of Section 15G.

86(a). How should the proportional reduction in risk retention be calculated? 86(b). What additional disclosures should the agencies require for collateral pools that include both qualifying and non-qualifying assets? 86(c). How would these additional disclosures enhance transparency and reduce the risk of sponsors taking advantage of information asymmetries? 86(d). Should a collateral pool that secures asset-backed securities be subject to a minimum total risk retention requirement of 2.5 percent? 86(e). If not, what would be an appropriate limit on the amount of qualifying assets that may be included in a collateral pool subject to 0 percent risk retention? 86(f). What other limiting mechanisms would be appropriate for mixed collateral pools?

87(a). Would a maturity mismatch limit such as the one discussed above (such that qualifying and non-qualifying assets do not have a difference in maturity of more than one year) be an appropriate requirement for collateral pools containing qualifying and non-qualifying assets? 87(b). How should such a limit be structured? 87(c). What other limits would be appropriate to address the investor and agency concerns discussed above?

#### E. Buyback Requirement

The original proposal provided that, if after issuance of a qualifying asset securitization, it was discovered that a loan did not meet the underwriting criteria, the sponsor would have to repurchase the loan. Industry commenters asserted that if the agencies retained this requirement, it should include a materiality standard. Alternately, these groups suggested that

the agencies allow curing deficiencies in the underwriting or loans instead of requiring buyback. Finally, industry commenters stated that they should not be responsible for post-origination problems with qualifying loans, and expressed concern that investors may seek to use the buyback requirement to make the sponsor repurchase poorly performing assets that met all the requirements at origination. Investor commenters, on the other hand, supported the buyback requirement as the sole remedy, and they opposed relying solely on representations and warranties.

The agencies have observed that during the recent financial crisis, investors who sought a remedy through representations and warranties often struggled through litigation with the sponsor or originator. Requiring the prompt repurchase of non-qualifying loans affords investors a clear path to remedy problems in the original underwriting. Therefore, the agencies are again proposing a buyback requirement for commercial, CRE, and automobile loans subsequently found not to meet the underwriting requirements for an exemption to the risk retention requirements. However, the agencies also agree with the sponsor commenters that buyback should not be the sole remedy, and therefore are proposing to allow a sponsor the option to cure a defect that existed at the time of origination to bring the loan into conformity with the proposed underwriting standards. Curing a loan should put the investor in no better or worse of a position than if the loan had been originated correctly. Some origination deficiencies may not be able to be cured after origination, and so for those deficiencies, buyback would remain the sole remedy.

The agencies also agree that buyback or cure should occur only when there are material problems with the qualifying loan that caused it not to meet the qualifying standards at origination. The agencies are not proposing any specific materiality standards in the rule, but believe that sponsors and investors could be guided by standards of materiality.<sup>131</sup>

Finally, as the agencies explained in the original proposal, the underwriting requirements need to be met only at the origination of the loan. Subsequent performance of the loan, absent any failure to meet the underwriting requirements at origination or failure of the loan to be current at the time of origination, would not be grounds for a

loan buyback or cure. The borrower's failure to meet its continuing obligations under the loan document covenants required for qualifying loan treatment, such as the requirement for periodic financial statements for CRE loans, would also not be grounds for a buyback or cure if the loan terms at origination appropriately imposed the obligation on the borrower.

#### Request for Comment

88. The agencies request comment on the buyback provision for qualifying loans, including on the proposed changes discussed above to allow cure and to incorporate a materiality standard.

## VI. Qualified Residential Mortgages

### A. Overview of Original Proposal and Public Comments

Section 15G of the Exchange Act exempts sponsors of securitizations from the risk retention requirements if all of the assets that collateralize the securities issued in the transaction are QRMs.<sup>132</sup> Section 15G directs the agencies to define QRM jointly, taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default. In addition, section 15G requires that the definition of a QRM be "no broader than" the definition of a QM.<sup>133</sup>

In developing the definition of a QRM in the original proposal,<sup>134</sup> the agencies articulated several goals and principles. First, the agencies stated that QRMs should be of very high credit quality, given that Congress exempted QRMs completely from the credit risk retention requirements. Second, the agencies recognized that setting fixed underwriting rules to define a QRM could exclude many mortgages to creditworthy borrowers. In this regard, the agencies recognized that a trade-off exists between the lower implementation and regulatory costs of providing fixed and simple eligibility requirements and the lower probability of default attendant to requirements that incorporate detailed and compensating underwriting factors. Third, the agencies sought to preserve a sufficiently large population of non-QRMs to help enable the market for securities backed by non-QRM mortgages to be relatively liquid. Fourth, the agencies sought to implement standards that would be

<sup>132</sup> See 15 U.S.C. 78o-11(c)(1)(C)(iii).

<sup>133</sup> See *id.* at section 78o-11(e)(4).

<sup>134</sup> See Original Proposal, 76 FR at 24117.

<sup>131</sup> See, e.g., *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

transparent and verifiable to participants in the market.

The agencies also sought to implement the statutory requirement that the definition of QRM be no broader than the definition of a QM, as mandated by the Dodd-Frank Act.<sup>135</sup> Under the original proposal, the agencies proposed to incorporate the statutory QM standards, in addition to other requirements, into the definition of a QRM and apply those standards strictly in setting the QRM requirements to ensure that the definition of QRM would be no broader than the definition of a QM. The agencies noted in the original proposal that they expected to monitor the rules adopted under TILA to define a QM and review those rules to determine whether changes to the definition of a QRM would be necessary or appropriate.

In considering how to determine if a mortgage is of sufficient credit quality, the agencies examined data from several sources.<sup>136</sup> Based on these and other data, the agencies originally proposed underwriting and product features that were robust standards designed to ensure that QRMs would be of very high credit quality.<sup>137</sup> A discussion of the

<sup>135</sup> See 15 U.S.C. 78o–11(e)(4)(C). At the time of issuance of the original proposal on April 29, 2011, the Board had sole rulemaking authority for defining QM, which authority transferred to CFPB on July 21, 2011, the designated transfer date under the Dodd-Frank Act.

<sup>136</sup> As provided in the original proposal, the agencies reviewed data supplied by McDash Analytics, LLC, a wholly owned subsidiary of Lender Processing Services, Inc. (LPS), on prime fixed-rate loans originated from 2005 to 2008, which included underwriting and performance information on approximately 8.9 million mortgages; data from the 1992 to 2007 waves of the triennial Survey of Consumer Finances (SCF), which focused on respondents who had purchased their homes either in the survey year or the previous year, and included information on approximately 1,500 families; and data regarding loans purchased or securitized by the Enterprises from 1997 to 2009, which consisted of more than 78 million mortgages, and included data on loan products and terms, borrower characteristics (e.g., income and credit score), and performance data through the third quarter of 2010. See 76 FR at 24152.

<sup>137</sup> The agencies acknowledged in the original proposal that any set of fixed underwriting rules likely would exclude some creditworthy borrowers. For example, a borrower with substantial liquid assets might be able to sustain an unusually high DTI ratio above the maximum established for a QRM. As this example indicates, in many cases sound underwriting practices require judgment about the relative weight of various risk factors (e.g., the tradeoff between LTV and DTI ratios). These decisions are usually based on complex statistical default models or lender judgment, which will differ across originators and over time. However, incorporating all of the tradeoffs, that may prudently be made as part of a secured underwriting process into a regulation would be very difficult without introducing a level of complexity and cost that could undermine any incentives for sponsors to securitize, and originators

full range of factors that the agencies considered in developing a definition of a QRM can be found in the original proposal.<sup>138</sup>

The agencies originally proposed to define QRM to mean a closed-end credit transaction to purchase or refinance a one-to-four family property at least one unit of which is the principal dwelling of a borrower that was not: (i) Made to finance the initial construction of a dwelling; (ii) a reverse mortgage; (iii) a temporary or “bridge” loan with a term of 12 months or less, such as a loan to purchase a new dwelling where the borrower plans to sell a current dwelling within 12 months; or (iv) a timeshare plan described in 11 U.S.C. 101(53D).<sup>139</sup> In addition, under the original proposal, a QRM (i) must be a first lien transaction with no subordinate liens; (ii) have a mortgage term that does not exceed 30 years; (iii) have maximum front-end and back-end DTI ratios of 28 percent and 36 percent, respectively; <sup>140</sup> (iv) have a maximum LTV ratio of 80 percent in the case of a purchase transaction, 75 percent in the case of rate and term refinance transactions, and 70 percent in the case of cash out refinancings; (v) include a 20 percent down payment from borrower funds in the case of a purchase transaction; and (vi) meet certain credit history restrictions.<sup>141</sup>

The agencies sought comment on the overall approach to defining QRM as well as on the impact of the QRM definition on the securitization market, mortgage pricing, and credit availability, including to low-to-moderate income borrowers. The agencies further requested comment on the proposed eligibility criteria of QRMs, such as the LTV, DTI, and borrower credit history standards.

to originate, QRMs. See Original Proposal, 76 FR at 24118.

<sup>138</sup> See Original Proposal, 76 FR at 24117–29.

<sup>139</sup> See *id.* at 24166.

<sup>140</sup> A front-end DTI ratio measures how much of the borrower’s gross (pretax) monthly income is represented by the borrower’s required payment on the first-lien mortgage, including real estate taxes and insurance. A back-end debt-to-income ratio measures how much of a borrower’s gross (pretax) monthly income would go toward monthly mortgage and nonmortgage debt service obligations.

<sup>141</sup> In order to facilitate the use of these standards for QRM purposes, the original proposal included as an appendix to the proposed rule (Additional QRM Standards Appendix) all of the standards in the HUD Handbook 4155–1 that are used for QRM purposes. (See HUD Handbook, available at [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/administration/hudclips/handbooks/hsg/4155.1](http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/handbooks/hsg/4155.1).) The only modifications made to the relevant standards in the HUD Handbook would be those necessary to remove those portions unique to the FHA underwriting process (e.g., TOTAL Scorecard instructions). See discussion in the Original Proposal, 76 FR at 24119.

The scope of the QRM definition generated a significant number of comments. Some commenters expressed support for the overall proposed approach to QRM, including the 20 percent down payment requirement of the QRM definition. These commenters asserted that an LTV requirement would be clear, objective, and relatively easy to implement, and represent an important determinant of a loan’s default probability.

However, the overwhelming majority of commenters, including individuals, industry participants (e.g., real estate brokers, mortgage bankers, securitization sponsors), insurance companies, public interest groups, state agencies, financial institutions and trade organizations, opposed various aspects of the originally proposed approach to defining QRM. In addition, many members of Congress commented that the proposed 20 percent down payment requirement was inconsistent with legislative intent, and strongly urged the agencies to eliminate or modify the down payment requirement.

Many commenters argued that the proposed QRM definition was too narrow, especially with respect to the LTV and DTI requirements. Many of these commenters asserted that the proposed QRM definition would prevent recovery of the housing market by restricting available credit, and as a result, the number of potential homebuyers. These commenters also argued that the proposed definition of QRM, especially when combined with the complexities of the proposed risk retention requirement that would have applied to non-QRMs, would make it difficult for private capital to compete with the Enterprises and thus, impede the return of private capital to the mortgage market. Many also asserted that the proposed LTV and DTI requirements favored wealthier persons and disfavored creditworthy low- and moderate-income persons and first-time homebuyers. A number of commenters believed that LTV and DTI elements of the proposed QRM definition would not only affect mortgages originated for securitization, but would likely also be adopted by portfolio lenders, magnifying the adverse effects described above. Other commenters claimed that the proposed QRM definition and proposed risk retention requirements would harm community banks and credit unions by increasing costs to those who purchase loans originated by these smaller institutions.

Some commenters urged the agencies to implement a more qualitative QRM standard with fewer numerical thresholds. Others argued for a matrix

system that would weigh compensating factors, instead of using an all-or-nothing approach to meeting the threshold standards. Commenters stated that requiring borrowers to put down more cash for a rate-and-term refinancing may prevent them from refinancing with safer and more economically desirable terms. Commenters were also critical of the proposed credit history requirements (in particular, the 30-day past due restriction), and the points and fees component of the proposed QRM definition.

Although a few commenters supported the inclusion of servicing standards in the QRM definition under the original proposal, the majority of those who submitted comment on this subject opposed the proposed servicing standards for a variety of reasons. For example, commenters asserted that servicing standards were not an underwriting standard or product feature, and were not demonstrated to reduce the risk of default. In addition, commenters stated that the proposed standards were too vague for effective compliance, and that the proposed rule's approach of requiring them to be terms of the mortgage loan would prevent future improvements in servicing from being implemented with respect to QRMs.

Many commenters urged the agencies to postpone finalizing the QRM definition until after the QM definition was finalized. Many commenters also advocated for the agencies to align the QRM definition to the QM definition.

#### B. Approach to Defining QRM

In determining the appropriate scope of the proposed QRM definition, the agencies carefully weighed a number of factors, including commenters' concerns, the cost of risk retention, current and historical data on mortgage lending and performance, and the recently finalized QM definition and other rules addressing mortgages. For the reasons discussed more fully below, the agencies are proposing to broaden and simplify the scope of the QRM exemption from the original proposal and define "qualified residential mortgage" to mean "qualified mortgage" as defined in section 129C of TILA<sup>142</sup> and implementing regulations, as may be amended from time to time.<sup>143</sup> The agencies propose to cross-reference the definition of QM, as defined by the CFPB in its regulations, to minimize potential for future conflicts between the QRM standards in the proposed rule

and the QM standards adopted under TILA.

The risk retention requirements are intended to address problems in the securitization markets by requiring securitizers to generally retain some economic interest in the credit risk of the assets they securitize (*i.e.*, have "skin in the game"). Section 15G of the Exchange Act requires the agencies to define a QRM exception from the credit risk retention requirement, taking into consideration underwriting and product features that historical loan performance data indicate result in a lower expected risk of default. The requirements of the QM definition are designed to help ensure that borrowers are offered and receive residential mortgage loans on terms that reasonably reflect their financial capacity to meet the payment obligations associated with such loans. The QM definition excludes many loans with riskier product features, such as negative amortization and interest-only payments, and requires consideration and verification of a borrower's income or assets and debt. This approach both protects the consumer and should lead to lower risk of default on loans that qualify as QM.

As discussed more fully below, the agencies believe a QRM definition that aligns with the definition of a QM meets the statutory goals and directive of section 15G of the Exchange Act to limit credit risk, preserves access to affordable credit, and facilitates compliance.

#### 1. Limiting Credit Risk

Section 129(C)(a) of TILA, as implemented by 12 CFR 1026.43(c), requires lenders to make a "reasonable and good faith determination" that a borrower has the ability to repay a residential mortgage loan. The QM rules provide lenders with a presumption of compliance with the ability-to-repay requirement. Together, the QM rules and the broader ability-to-repay rules restrict certain product features and lax underwriting practices that contributed significantly to the extraordinary surge in mortgage defaults that began in 2007.<sup>144</sup>

The QM rule does this, in part, by requiring documentation and verification of consumers' debt and income.<sup>145</sup> To obtain the presumption of compliance with the ability-to-repay requirement as a QM, the loan must have a loan term not exceeding 30 years; points and fees that generally do not

exceed 3 percent;<sup>146</sup> and not have risky product features, such as negative amortization, interest-only and balloon payments (except for those loans that qualify for the definition of QM that is only available to eligible small portfolio lenders).<sup>147</sup> Formal statistical models indicate that mortgages that do not meet these aspects of the QM definition rule are associated with a higher probability of default.<sup>148</sup>

Consistent with these statistical models, historical data indicate that mortgages that meet the QM criteria have a lower probability of default than mortgages that do not meet the criteria. This pattern is most pronounced for loans originated near the peak of the housing bubble, when non-traditional mortgage products and lax underwriting proliferated. For example, of loans originated from 2005 to 2008, 23 percent of those that met the QM criteria experienced a spell of 90-day or more delinquency or a foreclosure by the end of 2012, compared with 44 percent of loans that did not meet the QM criteria.<sup>149</sup>

In citing these statistics, the agencies are not implying that they consider a 23

<sup>146</sup> The QM definition provides a tiered-cap for points and fees for loan amounts less than \$100,000. *See id.* at 1026.43(e)(3).

<sup>147</sup> *See* 78 FR 35430 (June 12, 2013). In addition, the loan must have consumer debt payments that represent 43 percent or less of a borrower's income, or the loan must be eligible for purchase, guarantee or insurance by an Enterprise, HUD, the U.S. Department of Veteran Affairs, the U.S. Department of Agriculture, or the Rural Housing Service. *See* 12 CFR 1026.43(e)(2)(vi).

<sup>148</sup> *See* Shane M. Sherlund, "The Past, Present, and Future of Subprime Mortgages," *Finance and Economics Discussion Series*, Paper 2008-63 available at <http://www.federalreserve.gov/pubs/feds/2008/200863/200863pap.pdf>; Ronel Elul, Nicholas S. Souleles, Souphala Chomsisengphet, Dennis Glennon, and Robert Hunt, "What 'Triggers' Mortgage Default?" *American Economic Review* 100(2), 490-494 (May 2010).

<sup>149</sup> For purposes of this calculation, mortgages that do not meet the QM criteria are those with negative amortization, balloon, or interest-only features; those with no documentation; and those with DTI ratios in excess of 43 percent that were not subsequently purchased or guaranteed by the Enterprises or the FHA. Because of data limitations, loans with points and fees in excess of 3 percent and low-documentation loans that do not comply with the QM documentation criteria may be erroneously classified as QMs. The default estimates are based on data collected from mortgage servicers by Lender Processing Services and from securitized pools by CoreLogic. These data will under-represent mortgages originated and held by small depository institutions and adjustable-rate mortgages guaranteed by the FHA. The difference between delinquency statistics for QM and non-QM mortgages is consistent with a comparable tabulation estimated on loans securitized or purchased by the Enterprises. In the Enterprise analysis for loans originated from 2005 to 2008, 14 percent of those that met the QM criteria, compared with 33 percent of loans that did not meet the QM criteria, experienced a 90-day or more delinquency or a foreclosure by the end of 2012.

<sup>142</sup> 15 U.S.C. 1639c.

<sup>143</sup> *See* Final QM Rule.

<sup>144</sup> *See* Christopher Mayer, Karen Pence, and Shane M. Sherlund, "The Rise in Mortgage Defaults," *Journal of Economic Perspectives*, 23(1), 27-50 (Winter 2009).

<sup>145</sup> *See generally* 12 CFR 1026.43(c).

percent default rate to be an acceptable level of risk. The expansion in non-traditional mortgages and the lax underwriting during this period facilitated the steep rise in house prices and the subsequent sharp drop in house prices and surge in unemployment, and the default rates reflect this extraordinary macroeconomic environment. This point is underscored by the superior performance of more recent mortgage vintages. For example, of prime fixed-rate mortgages that comply with the QM definition, an estimated 1.4 percent of those originated from 2009 to 2010, compared with 16 percent of those originated from 2005 to 2008, experienced a 90-day or more delinquency or a foreclosure by the end of 2012.<sup>150</sup>

In the original proposal, the criteria for a QRM included an LTV ratio of 80 percent or less for purchase mortgages and measures of solid credit history that evidence low credit risk. Academic research and the agencies' own analyses indicate that credit history and the LTV ratio are significant factors in determining the probability of mortgage default.<sup>151</sup> However, these additional credit overlays may have ramifications for the availability of credit that many commenters argued were not outweighed by the corresponding reductions in likelihood of default from including these determinants in the QRM definition.

Moreover, the QM definition provides protections against mortgage default that are consistent with the statutory requirements. As noted above, risk retention is intended to align the interests of securitization sponsors and investors. Misalignment of these interests is more likely to occur where there is information asymmetry, and is particularly pronounced for mortgages with limited documentation and verification of income and debt. Academic studies suggest that securities collateralized by loans without full documentation of income and debt performed significantly worse than expected in the aftermath of the housing boom.<sup>152</sup>

<sup>150</sup> The higher default rate for the loans originated from 2005 to 2008 may reflect the looser underwriting standards in place at that time and the greater seasoning of these loans in addition to the changes in the macroeconomic environment. The estimates are shown only for prime fixed-rate mortgages because these mortgages have made up almost all originations since 2008.

<sup>151</sup> See Original Proposal, 76 FR at 24120–24124.

<sup>152</sup> See Benjamin J. Keys, Amit Seru, and Vikrant Vig, "Lender Screening and the Role of Securitization: Evidence from Prime and Subprime Mortgage Markets," *Review of Financial Studies*, 25(7) (July 2012); Adam Ashcraft, Paul Goldsmith-Pinkham, and James Vickery, "MBS Ratings and the

The QM definition limits the scope of this information asymmetry and misalignment of interests by requiring improved verification of income and debt. An originator that does not follow these verification requirements, in addition to other QM criteria, may be subject under TILA to potential liability and a defense to foreclosure if the consumer successfully claims he or she did not have the ability to repay the loan.<sup>153</sup> The potential risk arising from the consumer's ability to raise a defense to foreclosure extends to the creditor, assignee, or other holder of the loan for the life of the loan, and thereby may provide originators and their assignees with an incentive to follow verification and other QM requirements scrupulously.<sup>154</sup>

Other proposed and finalized regulatory changes are also intended to improve the quality and amount of information available to investors in QRM and non-QRM residential mortgage securitizations and incentivize originators and servicers to better manage mortgage delinquencies and potential foreclosures. These improvements may help to lessen the importance of broad "skin in the game" requirements on sponsors as an additional measure of protection to investors and the financial markets. For example, the Commission has proposed rules that, if finalized, would require in registered RMBS transactions disclosure of detailed loan-level information at the time of issuance and on an ongoing basis. The proposal also would require that securitizers provide investors with this information in sufficient time prior to the first sale of securities so that they can analyze this information when making their investment decision.<sup>155</sup> In addition, the CFPB has finalized loan originator compensation rules that help to reduce the incentives for loan originators to steer borrowers to unaffordable mortgages<sup>156</sup> as well as mortgage servicing rules that provide procedures and standards that servicers must follow when working with troubled borrowers in an effort to avoid

Mortgage Credit Boom," Federal Reserve Bank of New York Staff Report 449 (2010), available at [http://www.newyorkfed.org/research/staff\\_reports/sr449.html](http://www.newyorkfed.org/research/staff_reports/sr449.html).

<sup>153</sup> See sections 130(a) and 130(k) of TILA, 15 U.S.C. 1640.

<sup>154</sup> There are limits on the exposure to avoid unduly restricting market liquidity.

<sup>155</sup> See *Asset-Backed Securities*, Release Nos. 33–9117, 34–61858 75 FR 23328 at 23335, 23355 (May 3, 2010).

<sup>156</sup> See Loan Originator Compensation Requirements Under the Truth in Lending Act (Regulation Z); Final Rules, 78 FR 11280 (Feb. 15, 2013).

unnecessary foreclosures.<sup>157</sup> The Enterprises and the mortgage industry also have improved standards for due diligence, representations and warrants, appraisals, and loan delivery data quality and consistency.

## 2. Preserving Credit Access

Mortgage lending conditions have been tight since 2008, and to date have shown little sign of easing. Lending conditions have been particularly restrictive for borrowers with lower credit scores, limited equity in their homes, or with limited cash reserves. For example, between 2007 and 2012, originations of prime purchase mortgages fell about 30 percent for borrowers with credit scores greater than 780, compared with a drop of about 90 percent for borrowers with credit scores between 620 and 680.<sup>158</sup> Originations are virtually nonexistent for borrowers with credit scores below 620. These findings are also evident in the results from the Senior Loan Officer Opinion Survey. In the April 2012 Survey, a large share of lenders indicated that they were less likely than in 2006 to originate loans to borrowers with weaker credit profiles. In the April 2013 survey, lenders indicated that their appetite for making such loans had not changed materially over the previous year.<sup>159</sup>

Market conditions reflect a variety of factors, including various supervisory, regulatory, and legislative efforts such as the Enterprises' representations and warrants policies; mortgage servicing settlements reached with federal regulators and the state attorney generals; revised capital requirements; and new rules addressing all aspects of the mortgage lending process. These efforts are far-reaching and complex, and the interactions and aggregate effect of them on the market and participants are difficult to predict. Lenders may

<sup>157</sup> See Mortgage Servicing Rules Under the Truth in Lending Act (Regulation Z); Final Rule, 78 FR 10902 (Feb. 14, 2013); Mortgage Servicing Rules Under the Truth in Lending Act (Regulation Z); Final Rule, 78 FR 10696 (Feb. 14, 2013).

<sup>158</sup> These calculations are based on data provided by McDash Analytics, LLC, a wholly owned subsidiary of Lender Processing Services, Inc. The underlying data are provided by mortgage servicers. These servicers classify loans as "prime," "subprime," or "FHA." Prime loans include those eligible for sale to the Enterprises as well as those with favorable credit characteristics but loan sizes that exceed the Enterprises' guidelines ("jumbo loans").

<sup>159</sup> Data are from the Federal Reserve Board's Senior Loan Officer Opinion Survey on Bank Lending Practices. The April 2012 report is available at <http://www.federalreserve.gov/boarddocs/SnLoanSurvey/201205/default.htm> and the April 2013 report is available at <http://www.federalreserve.gov/boarddocs/SnLoanSurvey/201305/default.htm>.

continue to be cautious in their lending decisions until they have incorporated these regulatory and supervisory changes into their underwriting and servicing systems and gained experience with the rules.

The agencies are therefore concerned about the prospect of imposing further constraints on mortgage credit availability at this time, especially as such constraints might disproportionately affect groups that have historically been disadvantaged in the mortgage market, such as lower-income, minority, or first-time homebuyers.

The effects of the QRM definition on credit pricing and access can be separated into the direct costs incurred in funding the retained risk portion and the indirect costs stemming from the interaction of the QRM rule with existing regulations and current market conditions. The agencies' estimates suggest that the direct costs incurred by a sponsor for funding the retained portion should be small. Plausible estimates by the agencies range from zero to 30 basis points, depending on the amount and form of incremental sponsor risk retention, and the amount and form of debt in sponsor funding of incremental risk retention. The funding costs may be smaller if investors value the protections associated with risk retention and are thereby willing to accept tighter spreads on the securities.

However, the indirect costs stemming from the interaction of the QRM definition with existing regulations and market conditions are more difficult to quantify and have the potential to be large. The agencies judge that these costs are most likely to be minimized by aligning the QM and QRM definitions. The QM definition could result in some segmentation in the mortgage securitization market, as sponsors may be reluctant to pool QMs and non-QMs because of the lack of presumption of compliance available to assignees of non-QMs. As QRMs cannot be securitized with non-QRM under the proposed rule,<sup>160</sup> the QRM definition has the potential to compound this segmentation if the QM and QRM definitions are not aligned. Such segmentation could also lead to an increase in complexity, regulatory burden, and compliance costs, as lenders might need to set up separate underwriting and securitization platforms beyond what is already necessitated by the QM definition. These costs could be passed on to borrowers in the form of higher interest rates or tighter credit standards. Finally,

in addition to the costs associated with further segmentation of the market, setting a QRM definition that is distinct from the QM definition may interact with the raft of other regulatory changes in ways that are near-impossible to predict. Cross-referencing to the QM definition should facilitate compliance with QM and reduce these indirect costs.

The agencies recognize that aligning the QRM and QM definitions has the potential to intensify any existing bifurcation in the mortgage market between QM and non-QM loans, as securitizations collateralized by non-QMs could have higher funding costs due to risk retention requirements in addition to potential risk of legal liability under the ability-to-repay rule. The agencies acknowledge this risk but judge it to be smaller than the risk associated with further segmentation of the market.

If adopted, the agencies intend to review the advantages and disadvantages of aligning the QRM and QM definitions as the market evolves to ensure the rule best meets the statutory objectives of section 15G of the Exchange Act.

#### Request for Comment

89(a). Is the agencies' approach to considering the QRM definition, as described above, appropriate? 89(b). Why or why not? 89(c). What other factors or circumstances should the agencies take into consideration in defining QRM?

#### C. Proposed Definition of QRM

As noted above, Section 15G of the Exchange Act requires, among other things, that the definition of QRM be no broader than the definition of QM. The Final QM Rule is effective January 10, 2014.<sup>161</sup> The external parameters of what may constitute a QRM may continue to evolve as the CFPB clarifies, modifies or adjusts the QM rules.<sup>162</sup>

<sup>161</sup> See Final QM Rule.

<sup>162</sup> For example, the CFPB recently finalized rules to further clarify when a loan is eligible for purchase, insurance or guarantee by an Enterprise or applicable federal agency for purposes of determining whether a loan is a QM. See Amendments to the 2013 Mortgage Rules under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z), 78 FR 44686 (July 24, 2013). The CFPB also recently proposed rules that further address what amounts should be included as loan originator compensation in certain cases (*i.e.*, manufactured home loans) for purposes of calculating the 3 percent points and fees threshold under the QM rules. See Amendments to the 2013 Mortgage Rules under the Equal Credit Opportunity Act (Regulation B), Real Estate Settlement Procedures Act (Regulation X), and the Truth in Lending Act (Regulation Z), 78 FR 39902 (July 2, 2013).

Because the definition of QRM incorporates QM by reference, the proposed QRM definition would expressly exclude home-equity lines of credit (HELOCs), reverse mortgages, timeshares, and temporary loans or "bridge" loans of 12 months or less, consistent with the original proposal of QRM.<sup>163</sup> It would also expand the types of loans eligible as QRMs.<sup>164</sup> Under the original proposal, a QRM was limited to closed-end, first-lien mortgages used to purchase or refinance a one-to-four family property, at least one unit of which is the principal dwelling of the borrower. By proposing to align the QRM definition to the QM definition, the scope of loans eligible to qualify as a QRM would be expanded to include any closed-end loan secured by any dwelling (*e.g.*, home purchase, refinances, home equity lines, and second or vacation homes).<sup>165</sup>

Accordingly, the proposed scope of the QRM definition would differ from the original proposal because it would include loans secured by any dwelling (consistent with the definition of QM), not only loans secured by principal dwellings. In addition, if a subordinate lien meets the definition of a QM, then it would also be eligible to qualify as a QRM, whereas under the original proposal QRM-eligibility was limited to first-liens. The agencies believe the expansion to permit loans secured by any dwelling, as well as subordinate liens, is appropriate to preserve credit access and simplicity in incorporating the QM definition into QRM.

The CFPB regulations implementing the rules for a QM provide several definitions of a QM. The agencies propose that a QRM would be a loan that meets any of the QM definitions.<sup>166</sup>

These include the general QM definition, which provide that a loan must have:

- Regular periodic payments that are substantially equal;

<sup>163</sup> Also excluded would be most loan modifications, unless the transaction meets the definition of refinancing set forth in section 1026.20(a) of the Final QM rule, and credit extended by certain community based lending programs, down payment assistance providers, certain non-profits, and Housing Finance Agencies, as defined under 24 CFR 266.5. For a complete list, see 12 CFR 1026.43(a).

<sup>164</sup> See 12 CFR 1026.43(e)(2), which provides that QM is a covered transaction that meets the criteria set forth in §§ 1026.43(e)(2), (4), (5), (6) or (f). A "covered transaction" is defined to mean "a consumer credit transaction that is secured by a dwelling, as defined in § 1026.2(a)(19), including any real property attached to a dwelling, other than a transaction exempt from coverage under [§ 1026.43(a)]."

<sup>165</sup> See 12 CFR 1026.43(a).

<sup>166</sup> See 12 CFR 1026.43(e)(2), (e)(4), (e)(5), or (e)(6) or (f).

<sup>160</sup> See 15 U.S.C. 78o-11(c)(1)(B).

- 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, and current debt obligations, mortgage-related obligations, alimony and child support; and
- Total debt-to-income ratio that does not exceed 43 percent.

In recognition of the current mortgage market conditions and expressed concerns over credit availability, the CFPB also finalized a second temporary QM definition.<sup>167</sup> The agencies propose that a QRM would also include a residential mortgage loan that meets this second temporary QM definition. This temporary QM definition provides that a loan must have:

- 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
- Be eligible for purchase, guarantee or insurance by an Enterprise, HUD, the Veterans Administration, U.S. Department of Agriculture, or Rural Housing Service.<sup>168</sup>

Lenders that make a QM have a presumption of compliance with the ability-to-repay requirement under 129C(a) of TILA, as implemented by § 1026.43(c) of Regulation Z, and therefore obtain some protection from such potential liability.<sup>169</sup> However, there are different levels of protection from TILA liability<sup>170</sup> depending on

whether a QM is higher-priced or not.<sup>171</sup> QMs that are not higher-priced loans received a legal safe harbor for compliance with the ability-to-repay requirement, whereas QMs that are higher-priced covered transactions received a rebuttable presumption of compliance.<sup>172</sup> Both non-higher priced and higher-priced QMs would be eligible as QRMs without distinction, and could be pooled together in the same securitization.

The temporary QM definition for loans eligible for purchase or guarantee by an Enterprise expires once the Enterprise exits conservatorship.<sup>173</sup> In addition, the FHA, the U.S. Department of Veteran Affairs, the U.S. Department of Agriculture, and the Rural Housing Service each have authority under the Dodd-Frank Act to define QM for their own loans.<sup>174</sup> The temporary QM definition for loans eligible to be insured or guaranteed by one of these federal agencies expires once the relevant federal agency issues its own QM rules.<sup>175</sup>

Finally, the CFPB provided several additional QM definitions to facilitate credit offered by certain small creditors. The agencies propose that a QRM would be a QM that meets any of these three special QM definitions.<sup>176</sup> The Final QM Rule allows small creditors to originate loans as QMs with greater underwriting flexibility (e.g., no quantitative DTI threshold applies) than under the general QM definition.<sup>177</sup> However, this third QM definition is available only to small creditors that meet certain asset and threshold criteria<sup>178</sup> and hold the QM loans in portfolio for at least three years, with certain exceptions (e.g., transfer of a loan to another qualifying small creditor, supervisory sales, and merger and acquisitions).<sup>179</sup> Accordingly, loans meeting this third "small creditor" QM

discussion of the safe harbor and presumption of compliance, see 78 FR at 6510–6514.

<sup>171</sup> For the definition of higher-priced covered transaction, see 12 CFR 1026.43(b)(4) and accompanying commentary.

<sup>172</sup> For a detailed discussion of the safe harbor and presumption of compliance, see 78 FR at 6510–6514.

<sup>173</sup> See 12 CFR 1026.43(e)(4)(iii).

<sup>174</sup> See section 129C(b)(3)(B)(ii) of TILA; 15 U.S.C. 1639c.

<sup>175</sup> See 12 CFR 1026.43(e)(4)(iii).

<sup>176</sup> See 12 CFR 1026.43(e)(5), 12 CFR 1026.43(e)(6), and 12 CFR 1026.43(f).

<sup>177</sup> See 12 CFR 1026.43(e)(5).

<sup>178</sup> An entity qualifies as a "small creditor" if it does not exceed \$2 billion in total assets; originates 500 or fewer first-lien covered transactions in the prior calendar year (including all affiliates); and holds the QMs in portfolio for at least three years, with certain exceptions. See 12 CFR 1026.43(e)(5)(i)(D), discussed in detail in 78 FR at 35480–88 (June 12, 2013).

<sup>179</sup> See 12 CFR 1026.43(e)(5)(ii).

definition would generally be ineligible as QRMs for three years following consummation because they could not be sold.

The Final QM Rule also provides these eligible small creditors with a two-year transition period during which they can originate balloon loans that are generally held in portfolio, and meet certain criteria, as QRMs.<sup>180</sup> This two-year transition period expires January 10, 2016. Again, loans meeting this fourth QM definition would generally be ineligible as QRMs for three years following consummation. Last, the Final QM Rule allows eligible small creditors that operate predominantly in rural or underserved areas to originate balloon-payment loans as QMs if they are generally held in portfolio, and meet certain other QM criteria.<sup>181</sup> Loans meeting this third QM definition would also generally be ineligible for securitization for three years following consummation because they cannot be sold.

For the reasons discussed above, the agencies are not proposing to incorporate either an LTV ratio requirement or standards related to a borrower's credit history into the definition of QRM.<sup>182</sup> Furthermore, the agencies are not proposing any written appraisal requirement or assumability requirement as part of QRM. In response to comments, and as part of the simplification of the QRM exemption from the original proposal, the agencies are not proposing any servicing standards as part of QRM.

#### Request for Comment

The agencies invite comment on all aspects of the proposal to equate QRM with QM. In particular,

90. Does the proposal reasonably balance the goals of helping ensure high quality underwriting and appropriate risk management, on the one hand, and the public interest in continuing access to credit by creditworthy borrowers, on the other?

91. Will the proposal, if adopted, likely have a significant effect on the availability of credit? Please provide data supporting the proffered view.

92(a). Is the proposed scope of the definition of QRM, which would include loans secured by subordinate liens, appropriate? 92(b). Why or why not? 92(c). To what extent do concerns

<sup>180</sup> See 12 CFR 1026.43(e)(6), discussed in detail at 78 FR at 35488.

<sup>181</sup> See 12 CFR 1026.43(f).

<sup>182</sup> The agencies continue to believe that both LTV and borrower credit history are important aspects of prudent underwriting and safe and sound banking.

<sup>167</sup> 12 CFR 1026.43(e)(4).

<sup>168</sup> See 12 CFR 1206.43(e)(4)(ii).

<sup>169</sup> See section 129C(b)(1) of TILA, 15 U.S.C. 1639c(b)(1).

<sup>170</sup> Lenders that violate the ability-to-repay requirement may be liable for actual and statutory damages, plus court and attorney fees. Consumers can bring a claim for damages within three years against a creditor. Consumers can also raise a claim for these damages at any time in a foreclosure action taken by the creditor or an assignee. The damages are capped to limit the lender's liability. See sections 130(a), (e), and (k) of TILA, 15 U.S.C. 1640. However, the level of protection afforded differs depending on the loan's price. For a detailed

about the availability and cost of credit affect your answer?

93(a). Should the definition of QRM be limited to loans that qualify for certain QM standards in the final QM Rule? 93(b). For example, should the agencies limit QRMs to those QMs that could qualify for a safe harbor under 12 CFR 1026.43(e)(1)? Provide justification for your answer.

#### D. Exemption for QRMs

In order for a QRM to be exempted from the risk retention requirement, the proposal includes evaluation and certification conditions related to QRM status, consistent with statutory requirements. For a securitization transaction to qualify for the QRM exemption, each QRM collateralizing the ABS would be required to be currently performing (*i.e.*, the borrower is not 30 days or more past due, in whole or in part, on the mortgage) at the closing of the securitization transaction. Also, the depositor for the securitization would be required to certify that it evaluated the effectiveness of its internal supervisory controls to ensure that all of the assets that collateralize the securities issued out of the transaction are QRMs, and that it has determined that its internal supervisory controls are effective. This evaluation would be performed as of a date within 60 days prior to the cut-off date (or similar date) for establishing the composition of the collateral pool. The sponsor also would be required to provide, or cause to be provided, a copy of this certification to potential investors a reasonable period of time prior to the sale of the securities and, upon request, to the Commission and its appropriate Federal banking agency, if any.

#### Request for Comment

94(a). Are the proposed certification requirements appropriate? 94(b). Why or why not?

#### E. Repurchase of Loans Subsequently Determined To Be Non-Qualified After Closing

The original proposal provided that, if after the closing of a QRM securitization transaction, it was discovered that a mortgage did not meet all of the criteria to be a QRM due to inadvertent error, the sponsor would have to repurchase the mortgage. The agencies received a few comments regarding this requirement. Some commenters were supportive of the proposed requirement, while other commenters suggested that the agencies allow substitution of mortgages failing to meet the QRM definition.

The agencies are again proposing a buyback requirement for mortgages that are determined to not meet the QRM definition by inadvertent error after the closing of the securitization transaction, provided that the conditions set forth in section 12 of the proposed rules are met.<sup>183</sup> These conditions are intended to provide a sponsor with the opportunity to correct inadvertent errors by promptly repurchasing any non-qualifying mortgage loans from the pool. In addition, this proposed requirement would help ensure that sponsors have a strong economic incentive to ensure that all mortgages backing a QRM securitization satisfy all of the conditions applicable to QRMs prior to closing of the transactions. Subsequent performance of the loan, absent any failure to meet the QRM requirements at the closing of the securitization transaction, however, would not trigger the proposed buyback requirement.

#### Request for Comment

95(a). What difficulties may occur with the proposed repurchase requirement under the QRM exemption? 95(b). Are there alternative approaches that would be more effective? 95(c). Provide details and supporting justification.

#### E. Request for Comment on Alternative QRM Approach

Although the agencies believe that the proposed approach of aligning QRM with QM is soundly based, from both a policy and a legal standpoint, the agencies are seeking public input on its merits. The agencies are also seeking input on an alternative approach, described below, that was considered by the agencies, but ultimately not selected as the preferred approach. The alternative approach would take the QM criteria as a starting point for the QRM definition, and then incorporate additional standards that were selected to reduce the risk of default. Under this approach, significantly fewer loans likely would qualify as a QRM and, therefore, be exempt from risk retention.

#### 1. Description of Alternative Approach

The alternative approach, referred to as “QM-plus” would begin with the core QM criteria adopted by the CFPB, and then add four additional factors. Under this “QM-plus” approach:

- *Core QM criteria.* A QRM would be required to meet the CFPB’s core criteria

<sup>183</sup> Sponsors may choose to repurchase a loan from securitized pools even if there is no determination that the loan is not a QRM. The agencies would not view such repurchases as determinative of whether or not a loan meets the QRM standard.

for QM, including the requirements for product type,<sup>184</sup> loan term,<sup>185</sup> points and fees,<sup>186</sup> underwriting,<sup>187</sup> income and debt verification,<sup>188</sup> and DTI.<sup>189</sup> For loans meeting these requirements, the QM-plus approach would draw no distinction between those mortgages that fall within the CFPB’s “safe harbor” versus those that fall within the CFPB’s “presumption of compliance for higher-priced” mortgages.<sup>190</sup> Under QM-plus, either type of mortgage that meets the CFPB’s core criteria for QM would pass this element of the QM-plus test. Loans that are QM because they meet the CFPB’s provisions for GSE-eligible covered transactions, small creditor exceptions, or balloon loan provisions would, however, not be considered QRMs under the QM-plus approach.

- *One-to-four family principal dwelling.* In addition, QRM treatment would only be available for loans secured by one-to-four family real properties that constitute the principal dwelling of the borrower.<sup>191</sup> Other types of loans eligible for QM status, such as loans secured by a boat used as a residence, or loans secured by a consumer’s vacation home, would not be eligible under the QM-plus approach.

- *Lien requirements.* All QRMs would be required to be first-lien mortgages. For purchase QRMs, the QM-plus approach excludes so-called “piggyback” loans; no other recorded or perfected liens on the property could exist at closing to the knowledge of the originator. For refinance QRMs, junior liens would not be prohibited, but would be included in the LTV calculations described below.<sup>192</sup>

- *Credit history.* To be eligible for QRM status, the originator would be required to determine the borrower was not currently 30 or more days past due on any debt obligation, and the borrower had not been 60 or more days

<sup>184</sup> 12 CFR 1026.43(e)(2)(i).

<sup>185</sup> 12 CFR 1026.43(e)(2)(ii).

<sup>186</sup> 12 CFR 1026.43(e)(2)(iii); 12 CFR 1026.43(e)(3).

<sup>187</sup> 12 CFR 1026.43(e)(2)(iv).

<sup>188</sup> 12 CFR 1026.43(e)(2)(v).

<sup>189</sup> 12 CFR 1026.43(e)(2)(vi).

<sup>190</sup> *Cf.* 12 CFR 1026.43(e)(1)(i) with 12 CFR 1026.43(e)(1)(ii).

<sup>191</sup> The scope of properties that fall within the meaning of “one-to-four family property” and “principal dwelling” would be consistent with the definitions used in the agencies’ original QRM proposal in § .15(a), including consistent application of the meaning of the term “principal dwelling” as it is used in TILA (*see* 12 CFR 1026.2(a)(24) and Official Staff Interpretations to the Bureau’s Regulation Z, comment 2(a)(24)–3).

<sup>192</sup> These requirements are similar to those in the agencies’ original QRM proposal in § .15. *See* § .15(a) (definitions of “combined loan to value ratio” and “loan to value ratio”) and § .15(d)(2) (subordinate liens).

past due on any debt obligations within the preceding 24 months. Further, the borrower must not have, within the preceding 36 months, been a debtor in a bankruptcy proceeding or been subject to a judgment for collection of an unpaid debt; had personal property repossessed; had any one-to-four family property foreclosed upon; or engaged in a short sale or deed in lieu of foreclosure.<sup>193</sup>

- *Loan to value ratio.* To be eligible for QRM status, the LTV at closing could not exceed 70 percent. Junior liens, which would only be permitted for non-purchase QRMs as noted above, must be included in the LTV calculation if known to the originator at the time of closing, and if the lien secures a HELOC or similar credit plan, must be included as if fully drawn.<sup>194</sup> Property value would be determined by an appraisal, but for purchase QRMs, if the contract price at closing for the property was lower than the appraised value, the contract price would be used as the value.<sup>195</sup>

As discussed elsewhere in this Supplementary Information, the agencies' analysis of mortgage market data led the agencies to conclude that an approach that aligns QRM with QM covers most of the present mortgage market, and a significant portion of the historical market, putting aside non-traditional mortgages related primarily to subprime lending and lending with little documentation. This QM-plus approach would cover a significantly smaller portion of the mortgage market. Securitizers would be required to retain risk for QMs that do not meet the four factors above.

<sup>193</sup> These credit history criteria would be the same as the one used in the agencies' original QRM proposal in § 15(d)(5), including the safe harbor allowing the originator to make the required determination by reference to two credit reports.

<sup>194</sup> These requirements would be consistent with the approach used in the agencies' original QRM proposal in §§ 15(a) and 15(d)(9), except the same LTV would be used for purchases, refinancings, and cash-out refinancings. As the agencies discussed in the original proposal, there is data to suggest that refinance loans are more sensitive to LTV level. See Original Proposal at section IV.B.4. This single LTV approach in the QM-plus is equivalent to the most conservative LTV level (for cash-out refinancings) included in the original proposal.

<sup>195</sup> As in the agencies' original proposal, the appraisal would be required to be a written estimate of the property's market value, and be performed not more than 90 days prior to the closing of the mortgage transaction by an appropriately state-certified or state-licensed appraiser that conforms to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice promulgated by the Appraisal Standards Board of the Appraisal Foundation, the appraisal requirements of the Federal banking agencies, and applicable laws.

## Request for Comment

96(a). As documented in the initial proposal, academic research and the agencies' own analyses show that credit history and loan-to-value ratio are key determinants of mortgage default, along with the product type factors that are included in the QM definition.<sup>196</sup> If QRM criteria do not address credit history and loan-to-value, would securitizers packaging QRM-eligible mortgages into RMBS have any financial incentive to be concerned with these factors in selecting mortgages for inclusion in the RMBS pool? 96(b). Is the incentive that would be provided by risk retention unnecessary in light of the securitizer incentives and investor disclosures under an approach that aligns QRM with QM as described in the previous section of this **SUPPLEMENTARY INFORMATION**?

97(a). Does the QM-plus approach have benefits that exceed the benefits of the approach discussed above that aligns QRM with QM? For example, would the QM-plus approach favorably alter the balance of incentives for extending credit that may not be met by the QM definition approach or the QRM approach previously proposed? 97(b). Would the QM-plus approach have benefits for financial stability?

98. Would the QM-plus approach have greater costs, for example in decreased access to mortgage credit, higher priced credit, or increased regulatory burden?

99. Other than the different incentives described above, what other benefits might be obtained under the QM-plus approach?

## 2. Mortgage Availability and Cost

As discussed above, the overwhelming majority of commenters, including securitization sponsors, housing industry groups, mortgage bankers, lenders, consumer groups, and legislators opposed the agencies' original QRM proposal, recommending instead that almost all mortgages without features such as negative amortization, balloon payments, or teaser rates should qualify for an exemption from risk retention.<sup>197</sup> The basis for these commenters' objections was a unified concern that the proposal would result in a decrease in the availability of non-QRM mortgages and

<sup>196</sup> Original Proposal, section IV.B.2; section IV.B.3; section IV.B. 4; section IV.B.5; Appendix A to the **SUPPLEMENTARY INFORMATION**.

<sup>197</sup> Some commenters expressed support for additional factors, such as less stringent LTV restrictions, reliance on private mortgage insurance for loans with LTVs in excess of such restrictions, and different approaches to the agencies' proposed credit quality restrictions.

an increase in their cost. The other strong element of concern was that the original proposal's 20 percent purchase down payment requirement may have become a *de facto* market-wide standard, with harsh consequences for borrowers in economic circumstances that make it extremely difficult to save such sums.

In developing QRM criteria under section 15G, the agencies have balanced the benefits, including the public interest, with the cost and the other considerations. To the extent risk retention would impose any direct restriction on credit availability and price, the agencies proposed an approach that aligns QRM with QM, which directly reflects this concern.

There may be concerns, however, that the effect of aligning QRM with QM could ultimately decrease credit availability as lenders, and consequently securitizers, would be very reluctant to transact in non-QM loans. Since the QM criteria have been issued (and even before), many lenders have indicated they would not make any non-QM mortgages, expressing concern that they are uncertain of their potential liability under the TILA ability-to-repay requirements.

## Request for Comment

100(a). Would setting the QRM criteria to be the same as QM criteria give originators additional reasons to have reservations about lending outside the QM criteria? 100(b). Would the QM-plus approach, which confers a distinction on a much smaller share of the market than the approach that aligns QRM with QM, have a different effect?

Numerous commenters on the original QRM proposal asserted that lenders may charge significantly higher interest rates on non-QRM loans, with estimates ranging from 75 to 300 basis points. A limited number of these commenters described or referred to an underlying analysis of this cost estimate. The agencies take note that a significant portion of the costs were typically ascribed to provisions of the risk retention requirements that the agencies have eliminated from the proposal. As discussed in the previous section of this **SUPPLEMENTARY INFORMATION**, the agencies are considering the factors that will drive the incremental cost of risk retention. If the non-QRM market is small relative to the QRM market, investors might demand a liquidity premium for holding securities collateralized by non-QRMs. Investors might also demand a risk premium for holding these securities if non-QRMs are perceived to be lower-quality mortgages. If the scope of the non-QRM

market is sufficiently broad to avoid these types of premiums, the factors impacting cost will be the amount of additional risk retention that would be required under the rule, above current market practice, and the cost to the securitizer of funding and carrying that additional risk retention asset, reduced by the expected yield on that asset. There are a significant number of financial institutions that possess securitization expertise and infrastructure, and that also have management expertise in carrying the same type of ABS interests they would be required to retain under the rule; in fact, they have long carried large volumes of them as part of their business model. They also compete for securitization business and compete on mortgage pricing.

#### Request for Comment

101. In light of these factors, the agencies seek comment on whether the QM-plus approach would encourage a broader non-QRM market and thus mitigate concerns about the types of costs associated with a narrow QRM approach described above. Considering the number of institutions in the market with securitization capacity and expertise that already hold RMBS interests presenting the same types of risks as the RMBS interests the proposed rule now establishes as permissible forms of risk retention, would the requirement to retain risk in a greater number of securitizations under the QM-plus approach act as a restraint on the amount and cost of mortgage credit available in the market?

#### 3. Private Securitization Activity

In structuring the risk retention rules, the agencies have sought to minimize impediments to private securitization activity as a source of market liquidity for lending activity, and this principle has not been overlooked in the RMBS asset class. To the extent risk retention would impose any impediment to private securitization activity, the agencies proposed an approach that aligns QRM with QM to address that concern.

In response to the agencies' original QRM proposal, comments from RMBS investors generally supported the kinds of loan-to-value, credit history, and debt-to-income factors the agencies proposed.<sup>198</sup> While there were some

<sup>198</sup> For example, one such investor stated that the proposed QRM criteria were appropriate to maintain the proper balance between incentives for securitizers and mortgage credit availability. SIFMA Asset Management. Another expressed concern that broadening the QRM definition will give securitizers less "skin in the game" and increase

investors who expressed concern as to the exact calibration of the QRM requirements, on balance, these commenters expressed support for an approach that made risk retention the rule, not the exception.

Additionally, commenters recommended that the agencies examine data from the private securitization market in addition to the GSE data that was considered in the original proposal.

The agencies conducted two such analyses.<sup>199</sup> The first analysis was based on all securitized subprime and Alt-A loans originated from 2005 to 2008.<sup>200</sup> That analysis indicated that of such mortgages that did not meet the QM criteria, 52 percent experienced a serious delinquency by the end of 2012, where serious delinquency is defined as 90 or more days delinquent or in foreclosure. In contrast, 42 percent of such mortgages that met the QM criteria experienced a serious delinquency by the end of 2012.<sup>201</sup> If the set of QM-eligible mortgages were limited to those with a loan-to-value ratio of 70 percent or less, the serious delinquency rate falls to 27 percent. As discussed earlier in this **SUPPLEMENTARY INFORMATION**, these extraordinarily high delinquency rates reflect the sharp drop in house prices and surge in unemployment that occurred after the loans were originated, as well as lax underwriting practices. In addition, Alt-A and subprime loans are not reflective of the overall market and had many features that would exclude them from the QM definition, but data regarding these features were not always captured in the data sets.

The second analysis was based on all types of privately securitized loans originated from 1997 to 2009.<sup>202</sup> Although these data cover a broader range of loan types and years than the first analysis, subprime and Alt-A loans originated towards the end of the housing boom represent the bulk of all issuance during this period. That

investors' risk exposure, which is contrary to investors' long-term interests. Vanguard.

<sup>199</sup> The two analyses are not perfectly comparable. The first analysis included some loans with less than full documentation and the second analysis excluded no documentation loans. The second analysis used data with cumulative loan-to-value data while the first did not, and the second analysis used a credit overlay while the first did not.

<sup>200</sup> These data are a subset of the same data referenced in Part VI.B.1 of this Supplementary Information.

<sup>201</sup> These data do not include information on points and fees or full information on whether the loan met the QM documentation requirements. If these factors were taken into account, the delinquency rate on QM-eligible loans might be lower.

<sup>202</sup> See Part VIII.C.7.c, *infra* (Commission's Economic Analysis).

analysis indicated that 48 percent of mortgages that did not meet the QM criteria experienced a serious delinquency by the end of 2012, compared with 34 percent of mortgages that met the QM criteria. Limiting the set of QM-eligible mortgages to those with a loan-to-value ratio of 70 percent or less and a minimum FICO score of 690 resulted in a 12 percent serious delinquency rate, and when that set was further limited to a combined loan-to-value ratio of 70 percent or less, it resulted in a 6.4 percent serious delinquency rate.

The agencies also analyzed GSE data to compare delinquency rates of loans that would have met QM criteria with those of loans that would have met criteria approximating the QM-plus criteria—those with loan-to-value ratios of 70 percent or less, minimum FICO scores of 690, and debt-to-income ratios of no more than 43 percent. Those meeting the tighter criteria and originated in 2001–2004 had ever 90-day delinquency rates of 1.1 percent, compared with 3.9 percent for all QM loans. For loans originated in 2005–2008, the rates were 3.8 percent and 13.9 percent, respectively.

#### Request for Comment

102. How would the QM-plus approach influence investors' decisions about whether or not to invest in private RMBS transactions?

Another factor in investor willingness to invest in private label RMBS, as well as the willingness of originators to sell mortgages to private securitizers, concerns the presence of the Enterprises in the market, operating as they are under the conservatorship of the FHFA and with capital support by the U.S. Treasury.<sup>203</sup> Currently, the vast majority of residential mortgage securitization activity is performed by the Enterprises, who retain 100 percent of the risk of the mortgages they securitize.<sup>204</sup>

#### Request for Comment

103. How would the QM-plus approach affect or not affect investor appetite for investing in private label RMBS as opposed to securitizations guaranteed by the Enterprises?

The agencies note that the proposed requirements for risk retention have

<sup>203</sup> Groups representing securitizers and mortgage originators have recently expressed the view that restarting the private securitization market for conforming mortgages is dependent upon sweeping reform to the current role of the Enterprises. See, e.g., American Securitization Forum, *White Paper: Policy Proposals to Increase Private Capital in the U.S. Housing Finance System* (April 23, 2013); Mortgage Bankers Association, *Key Steps on the Road to GSE Reform* (August 8, 2013).

<sup>204</sup> Ginnie Mae plays the next largest role.

been significantly revised in response to commenter concerns about the original proposal. With respect to the costs of risk retention for sponsors and the possible effect that a QM-plus approach could have on their willingness to participate in the securitization market, the agencies request comment on whether risk retention could be unduly burdensome for sponsors or whether it would provide meaningful alignment of incentives between sponsors and investors.

#### Request for Comment

104. Since more RMBS transactions would be subject to risk retention under the QM-plus approach, how would the proposed forms of risk retention affect sponsors' willingness to participate in the market?

#### 4. Request for Comment About the Terms of the QM-Plus Approach

In addition, to the questions posed above, the agencies request public comment on a few specific aspects of the QM-plus approach, as follows.

##### a. Core QM Criteria

The QM-plus approach would only include mortgages that fall within the QM safe harbor or presumption of compliance under the core QM requirements. If a mortgage achieved QM status only by relying on the CFPB's provisions for GSE-eligible covered transactions, small creditors, or balloon loans, it would not be eligible for QRM status.<sup>205</sup>

#### Request for Comment

105. The agencies request comment whether the QM-plus approach should also include mortgages that fall within QM status only in reliance on the CFPB's provisions for GSE-eligible covered transactions, small creditors, or balloon loans. For all but the GSE-eligible covered transactions, the CFPB's rules make the mortgages ineligible for QM status if the originator sells them into the secondary market within three years of origination. For GSE-eligible loans, it appears sale to the GSEs may remain the best execution alternative for small originators (although the agencies are seeking comment on this point). The agencies request commenters advocating inclusion of these non-core QMs under the QM-plus approach to address

<sup>205</sup> Specifically, the QRM would need to be eligible for the safe harbor or presumption of compliance for a "qualified mortgage," as defined in regulations codified at 12 CFR 1026.43(e) and the associated Official Interpretations published in Supplement I to Part 1026, without regard to the special rules at 12 CFR 1026.43(e)(4)–(6) or 12 CFR 1026.43(f).

specifically how inclusion would improve market liquidity for such loans.

##### b. Piggyback Loans

For purchase QRMs, the QM-plus approach excludes so-called "piggyback" loans; no other recorded or perfected liens on the property could exist at closing of the purchase mortgage, to the knowledge of the originator at closing. The CFPB's QM requirements do not prohibit piggyback loans, but the creditor's evaluation of the borrower's ability to repay must include consideration of the obligation on the junior lien (similar to the treatment the QM-plus approach incorporates for junior liens on refinancing transactions). As the agencies discussed in the original proposal, the economic literature concludes that, controlling for other factors, including combined LTV ratios, the use of junior liens at origination of purchase mortgages to reduce down payments significantly increases the risk of default.<sup>206</sup>

#### Request for Comment

106. The agencies request comment whether, notwithstanding the agencies' concern about this additional risk of default, the agencies should remove the outright prohibition on piggyback loans from the QM-plus approach.

107(a). Commenters, including one group representing RMBS investors, expressed concern that excluding loans to a borrower that is 30 days past due on any obligation at the time of closing from the definition of QRM would be too conservative.<sup>207</sup> The QM-plus approach is based on the view that these 30-day credit derogatories are typically errors, or oversights by borrowers, that are identified to borrowers and eliminated during the underwriting process. Thus a 30-day derogatory that cannot be resolved before closing is an indication of a borrower who, as he or she approaches closing, is not meeting his or her obligations in a timely way. The agencies request comments from originators as to this premise. 107(b). The agencies also request comment on whether the QM-plus approach should permit a borrower to have a single 60-day plus past-due at the time of closing, but not two. 107(c). The agencies further request comment on whether this approach should be included if the borrower's single 60-day past-due is on a mortgage obligation.

In connection with the agencies' discussion elsewhere in this

<sup>206</sup> See Original Proposal at note 132 and accompanying text.

<sup>207</sup> ASF Investors.

Supplementary Information notice of underwriting criteria for commercial loans, commercial mortgages, and auto loans, the agencies have requested comment about permitting blended pools of qualifying and non-qualifying assets, with proportional reductions in risk retention.<sup>208</sup> Commenters are referred to an invitation to comment on blended pools with respect to residential mortgage securitizations that appears at the end of that discussion.

## VII. Solicitation of Comments on Use of Plain Language

Section 722 of the Gramm-Leach-Bliley Act, Public Law 106–102, sec. 722, 113 Stat. 1338, 1471 (Nov. 12, 1999), requires the Federal banking agencies to use plain language in all proposed and final rules published after January 1, 2000. The Federal banking agencies invite your comments on how to make this proposal easier to understand. For example:

- Have the agencies organized the material to suit your needs? If not, how could this material be better organized?

- Are the requirements in the proposed regulation clearly stated? If not, how could the regulation be more clearly stated?

- Does the proposed regulation contain language or jargon that is not clear? If so, which language requires clarification?

- Would a different format (grouping and order of sections, use of headings, paragraphing) make the regulation easier to understand? If so, what changes to the format would make the regulation easier to understand?

- What else could the agencies do to make the regulation easier to understand?

## VIII. Administrative Law Matters

### A. Regulatory Flexibility Act

*OCC:* The Regulatory Flexibility Act (RFA) generally requires that, in connection with a notice of proposed rulemaking, an agency prepare and make available for public comment an initial regulatory flexibility analysis that describes the impact of a proposed rule on small entities.<sup>209</sup> However, the regulatory flexibility analysis otherwise required under the RFA is not required if an agency certifies that the rule will not have a significant economic impact on a substantial number of small entities (defined in regulations promulgated by the Small Business Administration to include banking organizations with total assets of less than or equal to \$500

<sup>208</sup> See Part V.D of this SUPPLEMENTARY INFORMATION.

<sup>209</sup> See 5 U.S.C. 601 *et seq.*

million) and publishes its certification and a short, explanatory statement in the **Federal Register** together with the rule.

As discussed in the **SUPPLEMENTARY INFORMATION** above, section 941 of the Dodd-Frank Act<sup>210</sup> generally requires the Federal banking agencies and the Commission, and, in the case of the securitization of any residential mortgage asset, together with HUD and FHFA, to jointly prescribe regulations, that (i) require a securitizer to retain not less than 5 percent of the credit risk of any asset that the securitizer, through the issuance of an asset-backed security (ABS), transfers, sells, or conveys to a third party; and (ii) prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain under section 15G. Although the proposed rule would apply directly only to securitizers, subject to a certain considerations, section 15G authorizes the agencies to permit securitizers to allocate at least a portion of the risk retention requirement to the originator(s) of the securitized assets.

Section 15G provides a total exemption from the risk retention requirements for securitizers of certain securitization transactions, such as an ABS issuance collateralized exclusively by QRMs, and further authorizes the agencies to establish a lower risk retention requirement for securitizers of ABS issuances collateralized by other asset types, such as commercial, commercial real estate (CRE), and automobile loans, which satisfy underwriting standards established by the Federal banking agencies.

The risk retention requirements of section 15G apply generally to a “securitizer” of ABS, where securitizer is defined to mean (i) an issuer of an ABS; or (ii) a person who organizes and initiates an asset-backed transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer. Section 15G also defines an “originator” as a person who (i) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and (ii) sells an asset directly or indirectly to a securitizer.

The proposed rule implements the credit risk retention requirements of section 15G. Section 15G requires the agencies to establish risk retention requirements for “securitizers.” The proposal would, as a general matter, require that a “sponsor” of a

securitization transaction retain the credit risk of the securitized assets in the form and amount required by the proposed rule. The agencies believe that imposing the risk retention requirement on the sponsor of the ABS—as permitted by section 15G—is appropriate in light of the active and direct role that a sponsor typically has in arranging a securitization transaction and selecting the assets to be securitized. Under the proposed rule a sponsor may offset the risk retention requirement by the amount of any eligible vertical risk retention interest or eligible horizontal residual interest acquired by an originator of one or more securitized assets if certain requirements are satisfied, including, the originator must originate at least 20 percent of the securitized assets, as measured by the aggregate unpaid principal balance of the asset pool.

In determining whether the allocation provisions of the proposal would have a significant economic impact on a substantial number of small banking organizations, the Federal banking agencies reviewed December 31, 2012 Call Report data to evaluate the origination and securitization activity of small banking organizations that potentially could retain credit risk directly through their own securitization activity or indirectly under allocation provisions of the proposal.<sup>211</sup>

As of December 31, 2012, there were approximately 1,291 small national banks and Federal savings associations that would be subject to this rule. The Call Report data indicates that approximately 140 small national banks and Federal savings associations, originate loans to securitize themselves or sell to other entities for securitization, predominately through ABS issuances collateralized by one-to-four family residential mortgages. This number reflects conservative assumptions, as few small entities sponsor securitizations, and few originate a sufficient number of loans for securitization to meet the minimum 20 percent share for the allocation to originator provisions under the proposed rule. As the OCC regulates approximately 1,291 small entities, and

140 of those entities could be subject to this proposed rule, the proposed rule could impact a substantial number of small national banks and Federal savings associations.

The vast majority of securitization activity by small entities is in the residential mortgage sector. The majority of these originators sell their loans either to Fannie Mae or Freddie Mac, which retain credit risk through agency guarantees and would not be able to allocate credit risk to originators under this proposed rule. For those loans not sold to the Enterprises, most would likely meet the QRM exemption. The QM rule, on which the QRM proposal is based, also includes exceptions for small creditors, which may be utilized by many of these small entities to meet the requirements and thus not need to hold risk retention on those assets. For these reasons, the OCC believes the proposed rule would not have a substantial economic effect on small entities.

Therefore, the OCC concludes that the proposed rule would not have a significant impact on a substantial number of small entities. The OCC seeks comments on whether the proposed rule, if adopted in final form, would impose undue burdens, or have unintended consequences for, small national banks and Federal savings associations and whether there are ways such potential burdens or consequences could be minimized in a manner consistent with section 15G of the Exchange Act.

**Board:** The Regulatory Flexibility Act (5 U.S.C. 603(b)) generally requires that, in connection with a notice of proposed rulemaking, an agency prepare and make available for public comment an initial regulatory flexibility analysis that describes the impact of a proposed rule on small entities.<sup>212</sup> Under regulations promulgated by the Small Business Administration, a small entity includes a commercial bank or bank holding company with assets of \$500 million or less (each, a small banking organization).<sup>213</sup> The Board has considered the potential impact of the proposed rules on small banking organizations supervised by the Board in accordance with the Regulatory Flexibility Act.

For the reasons discussed in Part II of this Supplementary Information, the proposed rules define a securitizer as a “sponsor” in a manner consistent with the definition of that term in the Commission’s Regulation AB and provide that the sponsor of a

<sup>211</sup> Call Report Schedule RC-S provides information on the servicing, securitization, and asset sale activities of banking organizations. For purposes of the RFA analysis, the agencies gathered and evaluated data regarding (1) net securitization income, (2) the outstanding principal balance of assets sold and securitized by the reporting entity with servicing retained or with recourse or other seller-provided credit enhancements, and (3) assets sold with recourse or other seller-provided credit enhancements and not securitized by the reporting bank.

<sup>212</sup> See 5 U.S.C. 601 *et seq.*

<sup>213</sup> 13 CFR 121.201.

<sup>210</sup> Codified at section 15G of the Exchange Act, 17 U.S.C. 78o–11.

securitization transaction is generally responsible for complying with the risk retention requirements established under section 15G. The Board is unaware of any small banking organization under the supervision of the Board that has acted as a sponsor of a securitization transaction<sup>214</sup> (based on December 31, 2012 data).<sup>215</sup> As of December 31, 2012, there were approximately 5,135 small banking organizations supervised by the Board, which includes 4,092 bank holding companies, 297 savings and loan holding companies, 632 state member banks, 22 Edge and agreement corporations and 92 U.S. offices of foreign banking organizations.

The proposed rules permit, but do not require, a sponsor to allocate a portion of its risk retention requirement to one or more originators of the securitized assets, subject to certain conditions being met. In particular, a sponsor may offset the risk retention requirement by the amount of any eligible vertical risk retention interest or eligible horizontal residual interest acquired by an originator of one or more securitized assets if certain requirements are satisfied, including, the originator must originate at least 20 percent of the securitized assets, as measured by the aggregate unpaid principal balance of the asset pool.<sup>216</sup> A sponsor using this risk retention option remains responsible for ensuring that the originator has satisfied the risk retention requirements. In light of this option, the Board has considered the impact of the proposed rules on originators that are small banking organizations.

The December 31, 2012 regulatory report data<sup>217</sup> indicates that approximately 723 small banking organizations, 87 of which are small

banking organizations that are supervised by the Board, originate loans for securitization, namely ABS issuances collateralized by one-to-four family residential mortgages. The majority of these originators sell their loans either to Fannie Mae or Freddie Mac, which retain credit risk through agency guarantees and would not be able to allocate credit risk to originators under this proposed rule. Additionally, based on publicly-available market data, it appears that most residential mortgage-backed securities offerings are collateralized by a pool of mortgages with an unpaid aggregate principal balance of at least \$500 million.<sup>218</sup> Accordingly, under the proposed rule a sponsor could potentially allocate a portion of the risk retention requirement to a small banking organization only if such organization originated at least 20 percent (\$100 million) of the securitized mortgages. As of December 31, 2012, only one small banking organization supervised by the Board reported an outstanding principal balance of assets sold and securitized of \$100 million or more.<sup>219</sup>

In light of the foregoing, the proposed rules would not appear to have a significant economic impact on sponsors or originators supervised by the Board. The Board seeks comment on whether the proposed rules would impose undue burdens on, or have unintended consequences for, small banking organizations, and whether there are ways such potential burdens or consequences could be minimized in a manner consistent with section 15G of the Exchange Act.

**FDIC:** The Regulatory Flexibility Act (RFA) generally requires that, in connection with a notice of proposed rulemaking, an agency prepare and make available for public comment an initial regulatory flexibility analysis that describes the impact of a proposed rule on small entities.<sup>220</sup> However, a regulatory flexibility analysis is not required if the agency certifies that the rule will not have a significant

economic impact on a substantial number of small entities (defined in regulations promulgated by the Small Business Administration to include banking organizations with total assets of less than or equal to \$500 million) and publishes its certification and a short, explanatory statement in the **Federal Register** together with the rule.

As of March 31, 2013, there were approximately 3,711 small FDIC-supervised institutions, which include 3,398 state nonmember banks and 313 state-chartered savings banks. For the reasons provided below, the FDIC certifies that the proposed rule, if adopted in final form, would not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required.

As discussed in the **SUPPLEMENTARY INFORMATION** above, section 941 of the Dodd-Frank Act<sup>221</sup> generally requires the Federal banking agencies and the Commission, and, in the case of the securitization of any residential mortgage asset, together with HUD and FHFA, to jointly prescribe regulations, that (i) require a securitizer to retain not less than 5 percent of the credit risk of any asset that the securitizer, through the issuance of an asset-backed security (ABS), transfers, sells, or conveys to a third party; and (ii) prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain under section 15G. Although the proposed rule would apply directly only to securitizers, subject to a certain considerations, section 15G authorizes the agencies to permit securitizers to allocate at least a portion of the risk retention requirement to the originator(s) of the securitized assets.

Section 15G provides a total exemption from the risk retention requirements for securitizers of certain securitization transactions, such as an ABS issuance collateralized exclusively by QRMs, and further authorizes the agencies to establish a lower risk retention requirement for securitizers of ABS issuances collateralized by other asset types, such as commercial, commercial real estate (CRE), and automobile loans, which satisfy underwriting standards established by the Federal banking agencies.

The risk retention requirements of section 15G apply generally to a “securitizer” of ABS, where securitizer is defined to mean (i) an issuer of an ABS; or (ii) a person who organizes and

<sup>214</sup> For purposes of the proposed rules, this would include a small bank holding company; savings and loan holding company; state member bank; Edge corporation; agreement corporation; foreign banking organization; and any subsidiary of the foregoing.

<sup>215</sup> Call Report Schedule RC-S; Data based on the Reporting Form FR 2866b; Structure Data for the U.S. Offices of Foreign Banking Organizations; and Aggregate Data on Assets and Liabilities of U.S. Branches and agencies of Foreign Banks based on the quarterly form FFIEC 002.

<sup>216</sup> With respect to an open market CLO transaction, the risk retention retained by the originator must be at least 20 percent of the aggregate principal balance at origination of a CLO-eligible loan tranche.

<sup>217</sup> Call Report Schedule RC-S provides information on the servicing, securitization, and asset sale activities of banking organizations. For purposes of the RFA analysis, the agencies gathered and evaluated data regarding (1) the outstanding principal balance of assets sold and securitized by the reporting entity with servicing retained or with recourse or other seller-provided credit enhancements, and (2) assets sold with recourse or other seller-provided credit enhancements and not securitized by the reporting bank.

<sup>218</sup> Based on the data provided in Table 1, page 29 of the Board’s “Report to the Congress on Risk Retention,” it appears that the average MBS issuance is collateralized by a pool of approximately \$620 million in mortgage loans (for prime MBS issuances) or approximately \$690 million in mortgage loans (for subprime MBS issuances). For purposes of the RFA analysis, the agencies used an average asset pool size \$500 million to account for reductions in mortgage securitization activity following 2007, and to add an element of conservatism to the analysis.

<sup>219</sup> The FDIC notes that this finding assumes that no portion of the assets originated by small banking organizations were sold to securitizations that qualify for an exemption from the risk retention requirements under the proposed rule.

<sup>220</sup> See 5 U.S.C. 601 *et seq.*

<sup>221</sup> Codified at section 15G of the Exchange Act, 17 U.S.C. 78o-11.

initiates an asset-backed transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer. Section 15G also defines an “originator” as a person who (i) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and (ii) sells an asset directly or indirectly to a securitizer.

The proposed rule implements the credit risk retention requirements of section 15G. The proposal would, as a general matter, require that a “sponsor” of a securitization transaction retain the credit risk of the securitized assets in the form and amount required by the proposed rule. The agencies believe that imposing the risk retention requirement on the sponsor of the ABS—as permitted by section 15G—is appropriate in view of the active and direct role that a sponsor typically has in arranging a securitization transaction and selecting the assets to be securitized. The FDIC is aware of only 40 small banking organizations that currently sponsor securitizations (two of which are national banks, seven are state member banks, 23 are state nonmember banks, and eight are savings associations, based on March 31, 2013 information) and, therefore, the risk retention requirements of the proposed rule, as generally applicable to sponsors, would not have a significant economic impact on a substantial number of small state nonmember banks.

Under the proposed rule a sponsor may offset the risk retention requirement by the amount of any eligible vertical risk retention or eligible horizontal residual interest acquired by an originator of one or more securitized assets if certain requirements are satisfied, including, the originator must originate at least 20 percent of the securitized assets, as measured by the aggregate unpaid principal balance of the asset pool.<sup>222</sup> In determining whether the allocation provisions of the proposal would have a significant economic impact on a substantial number of small banking organizations, the Federal banking agencies reviewed March 31, 2013 Call Report data to evaluate the securitization activity and approximate the number of small banking organizations that potentially could retain credit risk under allocation provisions of the proposal.<sup>223</sup>

<sup>222</sup> With respect to an open market CLO transaction, the risk retention retained by the originator must be at least 20 percent of the aggregate principal balance at origination of a CLO-eligible loan tranche.

<sup>223</sup> Call Report Schedule RC-S provides information on the servicing, securitization, and asset sale activities of banking organizations. For

The Call Report data indicates that approximately 703 small banking organizations, 456 of which are state nonmember banks, originate loans for securitization, namely ABS issuances collateralized by one-to-four family residential mortgages. The majority of these originators sell their loans either to Fannie Mae or Freddie Mac, which retain credit risk through agency guarantees, and therefore would not be allocated credit risk under the proposed rule. Additionally, based on publicly-available market data, it appears that most residential mortgage-backed securities offerings are collateralized by a pool of mortgages with an unpaid aggregate principal balance of at least \$500 million.<sup>224</sup> Accordingly, under the proposed rule a sponsor could potentially allocate a portion of the risk retention requirement to a small banking organization only if such organization originated at least 20 percent (\$100 million) of the securitized mortgages. As of March 31, 2013, only two small banking organizations reported an outstanding principal balance of assets sold and securitized of \$100 million or more.<sup>225</sup>

The FDIC seeks comment on whether the proposed rule, if adopted in final form, would impose undue burdens, or have unintended consequences for, small state nonmember banks and whether there are ways such potential burdens or consequences could be minimized in a manner consistent with section 15G of the Exchange Act.

*Commission:* The Commission hereby certifies, pursuant to 5 U.S.C. 605(b), that the proposed rule, if adopted, would not have a significant economic impact on a substantial number of small entities. The proposed rule implements the risk retention requirements of section 15G of the Exchange Act, which,

purposes of the RFA analysis, the agencies gathered and evaluated data regarding (1) the outstanding principal balance of assets sold and securitized by the reporting entity with servicing retained or with recourse or other seller-provided credit enhancements, and (2) assets sold with recourse or other seller-provided credit enhancements and not securitized by the reporting bank.

<sup>224</sup> Based on the data provided in Table 1, page 29 of the Board’s “Report to the Congress on Risk Retention,” it appears that the average MBS issuance is collateralized by a pool of approximately \$620 million in mortgage loans (for prime MBS issuances) or approximately \$690 million in mortgage loans (for subprime MBS issuances). For purposes of the RFA analysis, the agencies used an average asset pool size \$500 million to account for reductions in mortgage securitization activity following 2007, and to add an element of conservatism to the analysis.

<sup>225</sup> The FDIC notes that this finding assumes that no portion of the assets originated by small banking organizations were sold to securitizations that qualify for an exemption from the risk retention requirements under the proposed rule.

in general, requires the securitizer of asset-backed securities (ABS) to retain not less than 5 percent of the credit risk of the assets collateralizing the ABS.<sup>226</sup> Under the proposed rule, the risk retention requirements would apply to “sponsors,” as defined in the proposed rule. Based on our data, we found only one sponsor that would meet the definition of a small broker-dealer for purposes of the Regulatory Flexibility Act.<sup>227</sup> Accordingly, the Commission does not believe that the proposed rule, if adopted, would have a significant economic impact on a substantial number of small entities.

A few commenters on the original proposal indicated that the proposed risk retention requirements could indirectly affect the availability of credit to small businesses and lead to contractions in the secondary mortgage market, with a corresponding reduction in mortgage originations. The Regulatory Flexibility Act only requires an agency to consider regulatory alternatives for those small entities subject to the proposed rules. The Commission has considered the broader economic impact of the proposed rules, including their potential effect on efficiency, competition and capital formation, in the Commission’s Economic Analysis below.

The Commission encourages written comments regarding this certification. The Commission requests, in particular, that commenters describe the nature of any direct impact on small entities and provide empirical data to support the extent of the impact.

*FHFA:* Pursuant to section 605(b) of the Regulatory Flexibility Act, FHFA hereby certifies that the proposed rule will not have a significant economic impact on a substantial number of small entities.

## B. Paperwork Reduction Act

### 1. Request for Comment on Proposed Information Collection

Certain provisions of the proposed rule contain “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995 (“PRA”), 44 U.S.C. 3501–3521. In accordance with the requirements of the PRA, the agencies may not conduct or sponsor, and the respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number. The information collection requirements contained in this joint notice of proposed rulemaking

<sup>226</sup> See 17 U.S.C. 780–11.

<sup>227</sup> 5 U.S.C. 601 *et seq.*

have been submitted by the FDIC, OCC, and the Commission to OMB for approval under section 3507(d) of the PRA and section 1320.11 of OMB's implementing regulations (5 CFR part 1320). The Board reviewed the proposed rule under the authority delegated to the Board by OMB.

Comments are invited on:

(a) Whether the collections of information are necessary for the proper performance of the agencies' functions, including whether the information has practical utility;

(b) The accuracy of the estimates of the burden of the information collections, including the validity of the methodology and assumptions used;

(c) Ways to enhance the quality, utility, and clarity of the information to be collected;

(d) Ways to minimize the burden of the information collections on respondents, including through the use of automated collection techniques or other forms of information technology; and

(e) Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

All comments will become a matter of public record. Commenters may submit comments on aspects of this notice that may affect disclosure requirements and burden estimates at the addresses listed in the **ADDRESSES** section of this Supplementary Information. A copy of the comments may also be submitted to the OMB desk officer for the agencies: By mail to U.S. Office of Management and Budget, 725 17th Street NW., #10235, Washington, DC 20503, by facsimile to 202-395-6974, or by email to: [oir\\_submission@omb.eop.gov](mailto:oir_submission@omb.eop.gov). Attention, Commission and Federal Banking Agency Desk Officer.

## 2. Proposed Information Collection

*Title of Information Collection:* Credit Risk Retention.

*Frequency of response:* Event generated; annual, monthly.

*Affected Public:*<sup>228</sup>

*FDIC:* Insured state non-member banks, insured state branches of foreign banks, state savings associations, and certain subsidiaries of these entities.

*OCC:* National banks, Federal savings associations, Federal branches or agencies of foreign banks, or any operating subsidiary thereof.

*Board:* Insured state member banks, bank holding companies, savings and loan holding companies, Edge and agreement corporations, foreign banking organizations, nonbank financial companies supervised by the Board, and any subsidiary thereof.

*Commission:* All entities other than those assigned to the FDIC, OCC, or Board.

*Abstract:* The notice sets forth permissible forms of risk retention for securitizations that involve issuance of asset-backed securities. The proposed rule contains requirements subject to the PRA. The information requirements in the joint regulations proposed by the three Federal banking agencies and the Commission are found in sections \_\_.4, \_\_.5, \_\_.6, \_\_.7, \_\_.8, \_\_.9, \_\_.10, \_\_.11, \_\_.13, \_\_.15, \_\_.16, \_\_.17, and \_\_.18. The agencies believe that the disclosure and recordkeeping requirements associated with the various forms of risk retention will enhance market discipline, help ensure the quality of the assets underlying a securitization transaction, and assist investors in evaluating transactions. Compliance with the information collections would be mandatory. Responses to the information collections would not be kept confidential and, except for the recordkeeping requirements set forth in sections \_\_.4(e) and \_\_.5(g)(2), there would be no mandatory retention period for the proposed collections of information.

### Section-by-Section Analysis

Section \_\_.4 sets forth the conditions that must be met by sponsors electing to use the standard risk retention option, which may consist of an eligible vertical interest or an eligible horizontal residual interest, or any combination thereof. Sections \_\_.4(d)(1) and \_\_.4(d)(2) specify the disclosures required with respect to eligible horizontal residual interests and eligible vertical interests, respectively.

A sponsor retaining any eligible horizontal residual interest (or funding a horizontal cash reserve account) is required to calculate the Closing Date Projected Cash Flow Rate and Closing Date Projected Principal Repayment Rate for each payment date, and certify to investors that it has performed such calculations and that the Closing Date Projected Cash Flow Rate on any payment date does not exceed the Closing Date Projected Principal Repayment Rate on such payment date (§ \_\_.4(b)(2)).

Additionally, the sponsor is required to disclose the fair value of the eligible horizontal residual interest retained by the sponsor and the fair value of the

eligible horizontal residual interest required to be retained (§ \_\_.4(d)(1)(i)); the material terms of the eligible horizontal residual interest (§ \_\_.4(d)(1)(ii)); the methodology used to calculate the fair value of all classes of ABS interests (§ \_\_.4(d)(1)(iii)); 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 (§ \_\_.4(d)(1)(iv)); the reference data set or other historical information used to develop the key inputs and assumptions (§ \_\_.4(d)(1)(v)); 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 pursuant to this section, 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 (§ \_\_.4(d)(1)(vi)); and the amount placed by the sponsor in the horizontal cash reserve account at closing, the fair value of the eligible horizontal residual interest that the sponsor is required to fund through such account, and a description of such account (§ \_\_.4(d)(1)(vii)).

For eligible vertical interests, the sponsor is required to disclose: whether the sponsor retains the eligible vertical interest as a single vertical security or as a separate proportional interest in each class of ABS interests in the issuing entity issued as part of the securitization transaction (§ \_\_.4(d)(2)(i)); for eligible vertical interests retained as a single vertical security, the fair value amount of the single vertical security retained at the closing of the securitization transaction and the fair value amount required to be retained, and the percentage of 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 would have been required to be retained if the eligible vertical interest was held as a separate proportional interest (§ \_\_.4(d)(2)(ii)); for eligible vertical interests retained as a separate proportional interest in each class of ABS interests in the issuing entity, the percentage of each class of ABS interests in the issuing entity retained at the closing of the securitization transaction and the percentage of each class of ABS

<sup>228</sup> The affected public of the FDIC, OCC, and Board is assigned generally in accordance with the entities covered by the scope and authority section of their respective proposed rule. The affected public of the Commission is based on those entities not already accounted for by the FDIC, OCC, and Board.

interests required to be retained (§ \_\_.4(d)(2)(iii)); and information with respect to the measurement of the fair value of the ABS interests in the issuing entity (§ \_\_.4(d)(2)(iv)).

Section \_\_.4(e) requires a sponsor to retain the certifications and disclosures required in paragraphs (b) and (d) of this section in written form in its records and must provide the disclosure upon request to the Commission and its appropriate Federal banking agency, if any, until three years after all ABS interests are no longer outstanding.

Section \_\_.5 requires sponsors relying on the revolving master trust risk retention option to disclose: The value of the seller's interest retained by the sponsor, the fair value of any horizontal risk retention retained by the sponsor under § \_\_.5(f), and the unpaid principal balance value or fair value, as applicable, the sponsor is required to retain (§ \_\_.5(g)(1)(i)); the material terms of the seller's interest and of any horizontal risk retention retained by the sponsor under § \_\_.5(f) (§ \_\_.5(g)(1)(ii)); and if the sponsor retains any horizontal risk retention under § \_\_.5(f), the same information as is required to be disclosed by sponsors retaining horizontal interests (§ \_\_.5(g)(1)(iii)). Additionally, a sponsor must retain the disclosures required in § \_\_.5(g)(1) in written form in its records and must provide the disclosure upon request to the Commission and its appropriate Federal banking agency, if any, until three years after all ABS interests are no longer outstanding (§ \_\_.5(g)(2)).

Section \_\_.6 addresses the requirements for sponsors utilizing the eligible ABCP conduit risk retention option. The requirements for the eligible ABCP conduit risk retention option include disclosure to each purchaser of ABCP and periodically to each holder of commercial paper issued by the ABCP conduit of the name and form of organization of the regulated liquidity provider that provides liquidity coverage to the eligible ABCP conduit, 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, the asset class or brief description of the underlying receivables, the standard industrial category code for the originator-seller or majority-owned OS affiliate that retains an interest in the securitization transaction, and a description of the form, fair value, and nature of such interest (§ \_\_.6(d)). An ABCP conduit sponsor relying upon this section shall provide, upon request, to the Commission and its appropriate Federal banking agency, if any, the

information required under § \_\_.6(d), in addition to the name and form of organization of each originator-seller or majority-owned OS affiliate that retains an interest in the securitization transaction (§ \_\_.6(e)).

A sponsor relying on the eligible ABCP conduit risk retention option shall maintain and adhere to policies and procedures to monitor compliance by each originator-seller or majority-owned OS affiliate (§ \_\_.6(f)(2)(i)). If the ABCP conduit sponsor determines that an originator-seller or majority-owned OS affiliate is no longer in compliance, the sponsor must promptly notify the holders of the ABCP, the Commission and its appropriate Federal banking agency, in writing of the name and form of organization of any originator-seller or majority-owned OS affiliate that fails to retain and the amount of asset-backed securities issued by an intermediate SPV of such originator-seller and held by the ABCP conduit, the name and form of organization of any originator-seller or majority-owned OS affiliate that hedges, directly or indirectly through an intermediate SPV, their risk retention in violation and the amount of asset-backed securities issued by an intermediate SPV of such originator-seller or majority-owned OS affiliate and held by the ABCP conduit, and any remedial actions taken by the ABCP conduit sponsor or other party with respect to such asset-backed securities (§ \_\_.6(f)(2)(ii)).

Section \_\_.7 sets forth the requirements for sponsors relying on the commercial mortgage-backed securities risk retention option, and includes disclosures of: The name and form of organization of each third-party purchaser (§ \_\_.7(a)(7)(i)); each initial third-party purchaser's experience in investing in commercial mortgage-backed securities (§ \_\_.7(a)(7)(ii)); other material information (§ \_\_.7(a)(7)(iii)); the fair value of the eligible horizontal residual interest retained by each third-party purchaser, the purchase price paid, and the fair value of the eligible horizontal residual interest that the sponsor would have retained if the sponsor had relied on retaining an eligible horizontal residual interest under the standard risk retention option (§ \_\_.7(a)(7)(iv) and (v)); a description of the material terms of the eligible horizontal residual interest retained by each initial third-party purchaser, including the same information as is required to be disclosed by sponsors retaining horizontal interests pursuant to § \_\_.4 (§ \_\_.7(a)(7)(vi)); the material terms of the applicable transaction documents with respect to the Operating Advisor (§ \_\_.7(a)(7)(vii); and

representations and warranties concerning the securitized assets, a schedule of any securitized assets that are determined not to comply with such representations and warranties, and the factors used to determine such securitized assets should be included in the pool notwithstanding that they did not comply with the representations and warranties (§ \_\_.7(a)(7)(viii)). A sponsor relying on the commercial mortgage-backed securities risk retention option shall provide in the underlying securitization transaction documents certain provisions related to the Operating Advisor (§ \_\_.7(a)(6)), maintain and adhere to policies and procedures to monitor compliance by third-party purchasers with regulatory requirements (§ \_\_.7(b)(2)(A)), and notify the holders of the ABS interests in the event of noncompliance by a third-party purchaser with such regulatory requirements (§ \_\_.7(b)(2)(B)).

Section \_\_.8 requires that a sponsor relying on the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation ABS risk retention option must disclose a description of the manner in which it has met the credit risk retention requirements (§ \_\_.8(c)).

Section \_\_.9 sets forth the requirements for sponsors relying on the open market CLO risk retention option, and includes disclosures of a complete list of, and certain information related to, every asset held by an open market CLO (§ \_\_.9(d)(1)), and the full legal name and form of organization of the CLO manager (§ \_\_.9(d)(2)).

Section \_\_.10 sets forth the requirements for sponsors relying on the qualified tender option bond risk retention option, and includes disclosures of the name and form of organization of the Qualified Tender Option Bond Entity, and a description of the form, fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and as a dollar amount), and nature of such interest in accordance with the disclosure obligations in section \_\_.4(d) (§ \_\_.10(e)).

Section \_\_.11 sets forth the conditions that apply when the sponsor of a securitization allocates to originators of securitized assets a portion of the credit risk it is required to retain, including disclosure of the name and form of organization of any originator that acquires and retains an interest in the transaction, a description of the form, amount and nature of such interest, and the method of payment for such interest (§ \_\_.11(a)(2)). A sponsor relying on this section shall maintain and adhere to

policies and procedures that are reasonably designed to monitor originator compliance with retention amount and hedging, transferring and pledging requirements (§ .11(b)(2)(A)) and shall promptly notify the holders of the ABS interests in the transaction in the event of originator noncompliance with such regulatory requirements (§ .11(b)(2)(B)).

Section .13 provides an exemption from the risk retention requirements for qualified residential mortgages that meet certain specified criteria, including that the depositor of the asset-backed security certify that it has evaluated the effectiveness of its internal supervisory controls and concluded that the controls are effective (§ .13(b)(4)(i)), and that the sponsor provide a copy of the certification to potential investors prior to sale of asset-backed securities (§ .13(b)(4)(iii)). In addition, § .13(c)(3) provides that a sponsor that has relied upon the exemption shall not lose the exemption if it complies with certain specified requirements, including prompt notice to the holders of the asset-backed securities of any loan repurchased by the sponsor.

Section .15 provides exemptions from the risk retention requirements for qualifying commercial loans that meet the criteria specified in Section .16, qualifying CRE loans that meet the criteria specified in Section .17, and qualifying automobile loans that meet the criteria specified in Section .18. Section .15 also requires the sponsor to disclose 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 commercial loans, qualifying CRE loans, and qualifying automobile loans (“qualifying assets”) and descriptions of the assets that are not qualifying assets, and the material differences between the group of qualifying assets and the group of assets that are not qualifying assets with respect to the composition of each group’s loan balances, loan terms, interest rates, borrower credit information, and characteristics of any loan collateral (§ .15(a)(4)).

Sections .16, .17 and .18 each require that: The depositor of the asset-backed security certify that it has evaluated the effectiveness of its internal supervisory controls and concluded that its internal supervisory controls are effective (§§ .16(b)(8)(i), .17(b)(10)(i), and .18(b)(8)(i)); the sponsor provide a copy of the

certification to potential investors prior to the sale of asset-backed securities (§§ .16(b)(8)(iii), .17(b)(10)(iii), and .18(b)(8)(iii)); and the sponsor promptly notify the holders of the securities of any loan included in the transaction that is required to be cured or repurchased by the sponsor, including the principal amount of such loan(s) and the cause for such cure or repurchase (§§ .16(c)(3), .17(c)(3), and .18(c)(3)).

#### *Estimated Paperwork Burden*

##### *Estimated Burden per Response:*

- § .4—Standard risk retention:  
Horizontal interests:  
Recordkeeping—0.5 hours, disclosures—3.0 hours, payment date disclosures—1.0 hour with a monthly frequency; vertical interests: Recordkeeping—0.5 hours, disclosures—2.5 hours; combined horizontal and vertical interests: Recordkeeping—0.5 hours, disclosures—4.0 hours, payment date disclosures—1.0 hour with a monthly frequency.
- § .5—Revolving master trusts:  
Recordkeeping—0.5 hours; disclosures—4.0 hours.
- § .6—Eligible ABCP conduits:  
Recordkeeping—20.0 hours; disclosures—3.0 hours.
- § .7—Commercial mortgage-backed securities: Recordkeeping—30.0 hours; disclosures—20.75 hours.
- § .8—Federal National Mortgage Association and Federal Home Loan Mortgage Corporation ABS:  
Disclosures—1.5 hours.
- § .9—Open market CLOs:  
Disclosures—20.25 hours.
- § .10—Qualified tender option bonds:  
Disclosures—4.0 hours.
- § .11—Allocation of risk retention to an originator: Recordkeeping 20.0 hours; disclosures 2.5 hours.
- § .13—Exemption for qualified residential mortgages:  
Recordkeeping—40.0 hours; disclosures 1.25 hours.
- § .15—Exemption for qualifying commercial loans, commercial real estate loans, and automobile loans:  
Disclosure—20.0 hours.
- § .16—Underwriting standards for qualifying commercial loans:  
Recordkeeping—40.0 hours; disclosures—1.25 hours.
- § .17—Underwriting standards for qualifying CRE loans:  
Recordkeeping—40.0 hours; disclosures—1.25 hours.
- § .18—Underwriting standards for qualifying automobile loans:  
Recordkeeping—40.0 hours; disclosures—1.25 hours.

FDIC

*Estimated Number of Respondents:* 92 sponsors; 494 annual offerings per year.  
*Total Estimated Annual Burden:* 10,726 hours.

OCC

*Estimated Number of Respondents:* 30 sponsors; 160 annual offerings per year.  
*Total Estimated Annual Burden:* 3,549 hours.

Board

*Estimated Number of Respondents:* 20 sponsors; 107 annual offerings per year.  
*Total Estimated Annual Burden:* 2,361 hours.

Commission

*Estimated Number of Respondents:* 107 sponsors; 574 annual offerings per year.  
*Total Estimated Annual Burden:* 12,355 hours.

#### *Commission’s explanation of the calculation:*

To determine the total paperwork burden for the requirements contained in this proposed rule the agencies first estimated the universe of sponsors that would be required to comply with the proposed disclosure and recordkeeping requirements. The agencies estimate that approximately 249 unique sponsors conduct ABS offerings per year. This estimate was based on the average number of ABS offerings from 2004 through 2012 reported by the ABS database AB Alert for all non-CMBS transactions and by Securities Data Corporation for all CMBS transactions. Of the 249 sponsors, the agencies have assigned 8 percent of these sponsors to the Board, 12 percent to the OCC, 37 percent to the FDIC, and 43 percent to the Commission.

Next, the agencies estimated the burden per response that would be associated with each disclosure and recordkeeping requirement, and then estimated how frequently the entities would make the required disclosure by estimating the proportionate amount of offerings per year for each agency. In making this determination, the estimate was based on the average number of ABS offerings from 2004 through 2012, and therefore, we estimate the total number of annual offerings per year to be 1,334.<sup>229</sup> We also made the following additional estimates:

<sup>229</sup> We use the ABS issuance data from Asset-Backed Alert on the initial terms of offerings, and we supplement that data with information from Securities Data Corporation (SDC). This estimate includes registered offerings, offerings made under Securities Act Rule 144A, and traditional private placements. We also note that this estimate is for offerings that are not exempted under §§ .19 and .20 of the proposed rule.

- 12 offerings per year will be subject to disclosure and recordkeeping requirements under section § \_\_.11, which are divided equally among the four agencies (*i.e.*, 3 offerings per year per agency);

- 100 offerings per year will be subject to disclosure and recordkeeping requirements under section § \_\_.13, which are divided proportionately among the agencies based on the entity percentages described above (*i.e.*, 8 offerings per year subject to § \_\_.13 for the Board; 12 offerings per year subject to § \_\_.13 for the OCC; 37 offerings per year subject to § \_\_.13 for the FDIC; and 43 offerings per year subject to § \_\_.13 for the Commission); and

- 120 offerings per year will be subject to the disclosure requirements under § \_\_.15, which are divided proportionately among the agencies based on the entity percentages described above (*i.e.*, 10 offerings per year subject to § \_\_.15 for the Board, 14 offerings per year subject to § \_\_.15 for the OCC; 44 offerings per year subject to § \_\_.15 for the FDIC, and 52 offerings per year subject to § \_\_.15 for the Commission. Of these 120 offerings per year, 40 offerings per year will be subject to disclosure and recordkeeping requirements under §§ \_\_.16, \_\_.17, and \_\_.18, respectively, which are divided proportionately among the agencies based on the entity percentages described above (*i.e.*, 3 offerings per year subject to each section for the Board, 5 offerings per year subject to each section for the OCC; 15 offerings per year subject to each section for the FDIC, and 17 offerings per year subject to each section for the Commission).

To obtain the estimated number of responses (equal to the number of offerings) for each option in subpart B of the proposed rule, the agencies multiplied the number of offerings estimated to be subject to the base risk retention requirements (*i.e.*, 1,114)<sup>230</sup> by the sponsor percentages described above. The result was the number of base risk retention offerings per year per agency. For the Commission, this was calculated by multiplying 1,114 offerings per year by 43 percent, which equals 479 offerings per year. This number was then divided by the number of base risk retention options under subpart B of the proposed rule (*i.e.*, nine)<sup>231</sup> to arrive at the estimate of

<sup>230</sup> Estimate of 1,334 offerings per year minus the estimate of the number of offerings qualifying for an exemption under §§ \_\_.13 and \_\_.15 (220 total).

<sup>231</sup> For purposes of this calculation, the horizontal, vertical, and combined horizontal and vertical risk retention methods under the standard risk retention option are each counted as a separate option under subpart B of the proposed rule.

the number of offerings per year per agency per base risk retention option. For the Commission, this was calculated by dividing 479 offerings per year by nine options, resulting in 53 offerings per year per base risk retention option.

The total estimated annual burden for each agency was then calculated by multiplying the number of offerings per year per section for such agency by the number of burden hours estimated for the respective section, then adding these subtotals together. For example, under § \_\_.10, the Commission multiplied the estimated number of offerings per year for § \_\_.10 (*i.e.*, 53 offerings per year) by the estimated annual frequency of the response for § \_\_.10 of one response, and then by the disclosure burden hour estimate for § \_\_.10 of 4.0 hours. Thus, the estimated annual burden hours for respondents to which the Commission accounts for the burden hours under § \_\_.10 is 212 hours (53 \* 1 \* 4.0 hours = 212 hours). The reason for this is that the agencies considered it possible that sponsors may establish these policies and procedures during the year independent on whether an offering was conducted, with a corresponding agreed upon procedures report obtained from a public accounting firm each time such policies and procedures are established.

For disclosures made at the time of the securitization transaction,<sup>232</sup> the Commission allocates 25 percent of these hours (1,070 hours) to internal burden for all sponsors. For the remaining 75 percent of these hours, (3,211 hours), the Commission uses an estimate of \$400 per hour for external costs for retaining outside professionals totaling \$1,284,400. For disclosures made after the time of sale in a securitization transaction,<sup>233</sup> the Commission allocated 75 percent of the total estimated burden hours (1,911 hours) to internal burden for all sponsors. For the remaining 25 percent of these hours (637 hours), the Commission uses an estimate of \$400 per hour for external costs for retaining outside professionals totaling \$254,800.

**FHFA:** The proposed regulation does not contain any FHFA information collection requirement that requires the approval of OMB under the Paperwork Reduction Act.

<sup>232</sup> These are the disclosures required by § \_\_.4(d)(1) and (2) (as applicable to horizontal interests, vertical interests, or any combination of horizontal and vertical interests); §§ \_\_.5(g)(1) through (3); \_\_.6(d) and (e); \_\_.7(a)(7)(i) through (viii); \_\_.8(c); \_\_.9(d); \_\_.10(e); \_\_.11(a)(2); \_\_.13(b)(4)(iii); \_\_.15(a)(4); \_\_.16(b)(8)(iii); \_\_.17(b)(10)(iii); and \_\_.18(b)(8)(iii).

<sup>233</sup> These are the disclosures required by §§ \_\_.4(b)(2); \_\_.6(f)(2)(ii); \_\_.7(b)(2)(B); \_\_.9(d); \_\_.11(b)(2)(B); \_\_.13(c)(3); \_\_.16(c)(3); \_\_.17(c)(3); and \_\_.18(c)(3).

**HUD:** The proposed regulation does not contain any HUD information collection requirement that requires the approval of OMB under the Paperwork Reduction Act.

### C. Commission Economic Analysis

#### 1. Introduction

As discussed above, Section 15G of the Exchange Act, as added by Section 941(b) of the Dodd-Frank Act, generally requires the agencies to jointly prescribe regulations, that (i) require a sponsor to retain not less than 5 percent of the credit risk of any asset that the sponsor, through the issuance of an asset-backed security (ABS), transfers, sells, or conveys to a third party, and (ii) prohibit a sponsor from directly or indirectly hedging or otherwise transferring the credit risk that the sponsor is required to retain under Section 15G and the agencies' implementing rules.<sup>234</sup>

Section 15G of the Exchange Act exempts certain types of securitization transactions from these risk retention requirements and authorizes the agencies to exempt or establish a lower risk retention requirement for other types of securitization transactions. For example, Section 15G specifically provides that a sponsor shall not be required to retain any part of the credit risk for an asset that is transferred, sold, or conveyed through the issuance of ABS by the sponsor, if all of the assets that collateralize the ABS are qualified residential mortgages (QRMs), as that term is jointly defined by the agencies.<sup>235</sup> In addition, Section 15G states that the agencies must permit a sponsor to retain less than 5 percent of the credit risk of commercial mortgages, commercial loans, and automobile loans that are transferred, sold, or conveyed through the issuance of ABS by the sponsor if the loans meet underwriting standards established by the Federal banking agencies.<sup>236</sup>

Section 15G requires the agencies to prescribe risk retention requirements for "securitizers," which the agencies interpret as depositors or sponsors of ABS. The proposal would require that a "sponsor" of a securitization transaction retain the credit risk of the securitized assets in the form and amount required by the proposed rule. The agencies believe that imposing the risk retention requirement on the sponsor of the ABS is appropriate in light of the active and direct role that a sponsor typically has

<sup>234</sup> See 15 U.S.C. 78o–11(b), (c)(1)(A) and (c)(1)(B)(ii).

<sup>235</sup> See *id.* at section 78o–11(c)(1)(C)(iii), (4)(A) and (B).

<sup>236</sup> See *id.* at section 78o–11(c)(1)(B)(ii) and (2).

in arranging a securitization transaction and selecting the assets to be securitized.

In developing the proposed rules, the agencies have taken into account the diversity of assets that are securitized, the structures historically used in securitizations, and the manner in which sponsors may have retained exposure to the credit risk of the assets they securitize. Moreover, the agencies have sought to ensure that the amount of credit risk retained is meaningful—consistent with the purposes of Section 15G—while reducing the potential for the proposed rules to negatively affect the availability and costs of credit to consumers and businesses.

As required by Section 15G, the proposed rules provide a complete exemption from the risk retention requirements for ABS collateralized solely by QRMs and establish the terms and conditions under which a residential mortgage would qualify as a QRM. In developing the proposed definition of a QRM, the agencies carefully considered the terms and purposes of Section 15G, public input, and the potential impact of a broad or narrow definition of QRM on the housing and housing finance markets.

The Commission is sensitive to the economic impacts, including the costs and benefits, of its rules. The discussion below addresses the economic effects of the proposed rules, including the likely benefits and costs of the rules as well as their effects on efficiency, competition and capital formation. Some of the economic effects stem from the statutory mandate of Section 15G, whereas others are affected by the discretion the agencies have exercised in implementing this mandate. These two types of costs and benefits may not be entirely separable to the extent that the agencies' discretion is exercised to realize the benefits that they believe were intended by Section 15G.

Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact on competition that the rules would have, and prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the Exchange Act.<sup>237</sup> Further, Section 3(f) of the Exchange Act requires the Commission,<sup>238</sup> when engaging in rulemaking where it is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of

investors, whether the action will promote efficiency, competition and capital formation.

## 2. Background

### a. Historical Background

Asset-backed securitizations, or the pooling of consumer and business loans into financial instruments that trade in the financial markets, play an important role in the creation of credit for the U.S. economy. Benefits of securitization may include reduced cost of credit for borrowers, expanded availability of credit, and increased secondary market liquidity for loans.<sup>239</sup> The securitization process generally involves the participation of multiple parties, each of whom has varying amounts of information and differing economic incentives. For example, the entity establishing and enforcing underwriting standards and credit decisions (*i.e.*, the originator) and the entity responsible for structuring the securitization (*i.e.*, the securitizer) are not required to bear any credit risk. By contrast, the ultimate holders of the securitized assets (*i.e.*, the investors) bear considerable credit risk and yet typically have minimal influence over underwriting standards and decisions and limited information about the characteristics of the borrower.

A considerable amount of literature has emerged that supports the view that, during the early to mid-2000s, residential mortgage-backed securitizations (RMBSs) contributed to a significant decline in underwriting standards for residential mortgage loans.<sup>240</sup> Much of the initial securitization issuance focused primarily on mortgages, which had guarantees from the Government National Mortgage Association (Ginnie Mae) or the Government Sponsored Enterprises (Enterprises), which included the Federal National Mortgage Association, also known as Fannie Mae, and the Federal Home Loan Mortgage Corporation, also known as Freddie Mac. Based on the initial success of these pass through securitizations<sup>241</sup>

<sup>239</sup> See, e.g., Board of Governors of the Federal Reserve System, "Report to the Congress on Risk Retention", (October 2010) and Financial Stability Oversight Committee, "Macroeconomic Effects of Risk Retention Requirements", (January 2011).

<sup>240</sup> Keys, Mukherjee, Seru and Vig, "Did Securitization Lead to Lax Screening? Evidence From Subprime Loans" (February 2010) and Nadauld and Sherlund, "The Impact of Securitization on the Expansion of Subprime Credit", (2013).

<sup>241</sup> Pass through securitization is considered the simplest and least complex way to securitize an asset. In this structure, investors receive a direct participation in the cash flows from a pool of assets. Payments on the securities are made in essentially

and investor demand and acceptance of these instruments, asset-backed securitizations subsequently expanded to include other asset classes (*e.g.*, car loans, student loans, credit card receivables, corporate loans and commercial mortgages). Over the years, securitizers began creating increasingly complex structures, including credit tranching and resecuritizations. As a result, securitizations increased over time in a variety of asset classes, providing investors with relatively attractive risk-return investment choices.

In the early 2000s, as securitizers sought additional assets to securitize, originators turned to a formerly lightly-tapped segment of the residential home market, known as the sub-prime market.<sup>242</sup> This segment serves the mortgage needs of individuals that are less credit worthy, generally for reasons related to income, assets and/or employment. The securitization of subprime loans facilitated the extension of credit to this segment of the market, which allowed securitizers to generate more collateral for the securitization market and led to a significant increase in the availability of low credit quality mortgage loans for purposes of meeting the relatively high demand for securitized investment products. This high volume of lending contributed to higher residential property prices.<sup>243</sup> A contributing factor to the increase in housing prices was the unrealistically high ratings provided by credit rating agencies on residential mortgage-backed securities.<sup>244</sup> Many investors may not have performed independent credit assessments, either due to a lack of transparency into the characteristics of the underlying assets or an undue reliance on credit rating agencies that provided third-party credit evaluations. This situation persisted until a high

the same manner as payments on the underlying loans. Principal and interest are collected on the underlying assets and 'passed through' to investors without any tranching or structuring or reprioritization of the cash flows.

<sup>242</sup> Dell'Araccia, Deniz and Laeven, "Credit Booms and Lending Standards: Evidence From the Subprime Mortgage Market", (2008); Mian and Sufi, "The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis", (2008); Puranandam, "Originate-to-Distribute Model and the Sub-Prime Mortgage Crisis", (2008).

<sup>243</sup> Board of Governors of the Federal Reserve, "Report to the Congress on Risk Retention", (October 2010).

<sup>244</sup> See, e.g., Benmelech and Dlugosz, 2010, The Credit Rating Crisis, Chapter 3 of NBER Macroeconomics Annual 2009, Vol. 24, pp. 161–207, Acemoglu, Rogoff and Woodford, eds., University of Chicago Press; Bolton, Freixas and Shapiro, "The Credit Ratings Game" Journal of Finance (February 2012); Griffin and Tang, "Did Subjectivity Play a Role in CDO Credit Ratings", Working paper (2010).

<sup>237</sup> 15 U.S.C. 78w(a).

<sup>238</sup> 17 U.S.C. 78c(f).

number of defaults and an increase in interest rates led to subsequent declines in housing prices. The “originate-to-distribute” model was blamed by many for these events, as the originators and securitizers were compensated on the basis of volume rather than quality of underwriting. Because lenders often did not expect to bear the risk of borrower default in connection with those loans that were securitized and sold to third-party investors, the lenders had little ongoing economic interest in the performance of the securitization.<sup>245</sup>

#### b. Broad Economic Considerations

While securitization can redistribute financial risks in ways that provide significant economic benefits, certain market practices related to its implementation can potentially undermine the efficiency of the market. In particular, securitization removes key features of the classic borrower-lender relationship, which relies on borrower and lender performance incentives generated from repeated interactions, as well as the ongoing communication of proprietary information between the borrower and the lender. The separation between the borrower and the ultimate provider of credit in securitization markets can introduce significant informational asymmetries and misaligned incentives between the originators and the ultimate investors. In particular, the originator has more information about the credit quality and other relevant characteristics of the borrower than the ultimate investors,

which could introduce a moral hazard problem—the situation where one party (*e.g.*, the loan originator) may have a tendency to incur risks because another party (*e.g.*, investors) will bear the costs or burdens of these risks. Hence, when there are inadequate processes in place to encourage (or require) sufficient transparency to overcome concerns about informational differences, the securitization process could lead certain participants to maximize their own welfare and interests at the expense of other participants.

For example, in the RMBS market, mortgage originators generally have more information regarding a borrower’s ability to repay a loan obligation than the investors that ultimately own the economic interest, as the originator collects and evaluates information to initiate the mortgage. In a securitization, since ABS investors typically do not participate in this process, they likely have less information about expected loan performance than the originators. Disclosures to investors may not be sufficiently detailed regarding the quality of the underlying assets to adequately evaluate the assets backing the security. In addition, in a securitization the underlying pool is comprised of hundreds or thousands of loans, each requiring time to evaluate. Thus, such information asymmetry may have an adverse impact on investors, especially in the case when the originator and securitizer receive full compensation before the time when investors ultimately learn about loan

quality. Consequently, the originator may have incentive to approve and fund a loan that they would not otherwise. In other words, the originator may be less diligent in solving the adverse selection problem since the consequences are transferred to the investors.

The securitization process removes (or lessens) the consequences of poor loan performance from the loan originators, whose compensation depends primarily on the fees generated during the origination process. This provides economic incentive to produce as many loans as possible because loan origination, structuring, and underwriting fees for securitizations reward transaction volume. Without the requirement by the market to bear any of the risk associated with subsequent defaults, this can result in potentially misaligned incentives between the originators and the ultimate investors.<sup>246</sup> Through the securitization process, risk is transferred from the originators to investors, who in the absence of transparency into the composition of the underlying assets, may rely too readily on credit rating agency assessments of the underlying loans and credit enhancement supporting the securitization. In the years preceding the financial crisis, these incentives may have motivated originators to structure mortgage securitizations with little or no credit enhancement and extend credit to less creditworthy borrowers, whose subsequent defaults ultimately helped to trigger the crisis.

TABLE 1—RATING PERFORMANCE OF PRIME RMBS (%)

Year	Issues	All		AAA			Investment grade			Speculative grade			Likely to default		
		Up	Down	Share	Up	Down	Share	Up	Down	Share	Up	Down	Share	Up	Down
2004	15,512	3.5	0.0	80.9	0.0	0.0	14.3	23.3	0.0	4.4	4.6	0.1	0.2	0.0	0.0
2005	14,474	4.6	0.1	72.1	0.0	0.0	18.6	20.9	0.1	8.9	7.4	0.7	0.2	0.0	0.0
2006	16,859	3.1	0.1	71.0	0.0	0.0	18.7	13.8	0.1	9.9	5.8	0.8	0.2	0.0	14.3
2007	18,452	1.8	0.2	72.1	0.0	0.0	17.9	8.5	0.3	9.7	2.6	1.1	0.2	0.0	21.4
2008	20,924	0.5	12.4	73.7	0.0	9.9	16.8	2.5	13.0	9.3	1.4	31.1	0.2	0.0	45.0
2009	20,475	0.0	46.4	65.6	0.0	32.0	21.2	0.0	69.0	9.5	0.0	81.7	3.7	0.0	91.2
2010	19,700	0.1	29.0	42.5	0.0	12.8	16.3	0.2	44.8	12.9	0.0	64.4	28.3	0.1	34.3
2011	18,338	0.3	36.7	36.9	0.0	14.4	14.2	0.6	62.3	10.8	0.9	81.3	38.1	0.5	49.4
2012	16,886	0.2	16.3	27.4	0.0	3.6	10.7	0.0	31.3	10.8	0.6	24.7	51.1	0.4	27.8

**Notes:** The numbers in the table were calculated by Division of Economic and Risk Analysis (DERA) staff using the Standard & Poor’s (S&P) RatingsXpress data. These statistics are for securities issued by U.S. entities in U.S. dollars, carrying a local currency rating, and having a rating on the scale of AAA to D. Each security is assigned to an asset class based on the collateral type information provided by S&P. Securities backed by collateral that mixes multiple types of assets are not included. “Issues” is the total number of RMBS issuances outstanding as of January 1 for each year. “Share” is the share of each rating category among all rated RMBS. Upgrades and downgrades are expressed as a percentage of all rated securitizations in a specified year and in a specified rating class. “Investment Grade” (IG) are ratings from AA+ to BBB–, “Speculative” are from BB+ to B–, and “Likely to Default” are CCC+ and below.

<sup>245</sup> Dell’Ariccia, Deniz and Laeven, “Credit Booms and Lending Standards: Evidence From the Subprime Mortgage Market”, (2008), Mian and Sufi, “The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis”, (2008), Puranandam, “Originate-to-Distribute Model and the Sub-Prime Mortgage Crisis”, (2008), Keys, Mukherjee, Seru and Vig, “Did Securitization Lead

to Lax Screening? Evidence from Subprime Loans” (February 2010) and Nadauld and Sherlund, “The Impact of Securitization on the Expansion of Subprime Credit”, (2013).

<sup>246</sup> As an example, Ashcraft and Schuermann (2008) identify at least seven different frictions in the residential mortgage securitization chain that

can cause agency and adverse selection problems in a securitization transaction. The main point of their analysis is that there are many different parties in a securitization transaction, each with differing economic interests and incentives. Hence, there are multiple opportunities for conflicts of interest to arise in such structures.

Evidence of the credit worthiness of borrowers during this period is illustrated in Table 1, which shows that 9.9 percent of presumably low-risk securities, such as AAA-rated non-agency RMBS, outstanding in 2008 were downgraded during 2008. More significantly 32.0 percent of these securities outstanding in 2009 were downgraded during the year. Thus, almost one third of the outstanding RMBS securities with the highest possible credit rating were downgraded during 2009, suggesting that the credit quality of the underlying collateral and underlying credit enhancement for AAA notes was far poorer than originally rated by the credit rating agencies.

The downgrades serve to illustrate the extent to which misaligned incentives between originators/sponsors of ABS and the ultimate investors may have manifested in the form of lax lending standards and relaxed credit enhancement standards during the period before the financial crisis. Risk retention is one possible response to this problem. Requiring securitizers to share the same risks as the investors that purchase these products seeks to mitigate the problems caused by misaligned incentives. By retaining loss exposure to the securitized assets, securitizers are considered to have “skin in the game” and thus are economically motivated to be more judicious in their selection of the underlying pool of assets, thereby helping to produce higher quality (*i.e.*, lower probability of default) securities.

Currently, sponsors who do not retain 5 percent of the securitization likely deploy those funds to other uses, such as repaying lines of credit used to fund securitized loans, holding other assets or making new loans, which may earn a different interest rate and have a different risk exposure. Therefore, a risk retention requirement could impose costs to those sponsors who do not currently hold risk, in the form of the opportunity costs of those newly tied-up funds, or could limit the volume of securitizations that they can perform. These costs will likely be passed onto borrowers, either in terms of borrowing costs or access to capital. In particular, borrowers whose loans do not meet the eligibility requirements or qualify for an exemption (*i.e.*, those that require risk retention when securitized by the ABS originator/sponsor) will face increased borrowing costs, or be priced out of the loan market, thus restricting their access to capital. As a result, there could be a negative impact on capital formation.

Hence, there are significant potential costs to the implementation of risk retention requirements in the

securitization market. The Commission notes that the costs will also be impacted by any returns and timing of the returns of any retained interest. If the costs are deemed by sponsors to be onerous enough that they would no longer be able to earn a sufficiently high expected return by sponsoring securitizations, this form of supplying capital to the underlying asset markets would decline. Fewer asset securitizations would require other forms of funding to emerge in order to serve the needs of borrowers and lenders. Given the historically large dollar volumes in the securitization markets, this could reduce capital flows into the underlying asset markets, thereby reducing the amount of capital available for lending and possibly adversely impacting efficiency.

The net impact of this outcome depends on the availability of alternative arrangements for transferring capital to the underlying assets markets and the costs of transferring capital to sponsors. For example, the impact of the potential decrease in the use of securitizations in the residential home mortgage market would depend on the cost and availability of alternative mortgage funding sources, and the willingness of these originators to retain the full burden of the associated risks. To the extent there are alternatives, and these alternatives can provide funding on terms similar to those available in the securitization markets, the impact of the substitution of these alternatives for securitizations would likely be minimal. To the extent that securitizers can find sources of capital at costs similar to the returns paid on retained interests, the impact of risk retention requirements would likely be minimal. Currently, however, there is little available empirical evidence to reliably estimate the cost and consequence of either such outcome.

To maintain a commensurate level of funding to underlying asset markets with the risk retention requirement, the rates on the underlying assets would have to increase so that sponsors could achieve their higher target returns by serving the securitization market. Two recent studies by the Federal Reserve Bank of New York attempt to estimate the impact of the higher risk retention on the underlying asset markets.<sup>247</sup> Their analysis suggests that incremental sponsor return requirements for serving markets with the higher levels of risk retention are relatively modest, somewhere on the order of 0–30 basis

points.<sup>248</sup> If so, the higher levels of risk retention would increase residential mortgage rates by approximately 0.25 percent. While this would increase the average borrower cost for loans that would not otherwise be eligible for securitizations exempt from risk retention, the increment may be sufficiently small such that securitizations would be expected to remain a significant component of the capital formation process.

### 3. Economic Baseline

The baseline the Commission uses to analyze the economic effects of the risk retention requirements added by Section 15G of the Exchange Act is the current set of rules, regulations, and market practices that may determine the amount of credit exposure retained by securitizers. To the extent not already followed by current market practices, the proposed risk retention requirements will impose new costs. The risk retention requirements will affect ABS market participants, including loan originators, securitizers and investors in ABS, and consumers and businesses that seek access to credit. The costs and benefits of the risk retention requirements depend largely on the current market practices specific to each securitization market—including current risk retention practices—and corresponding asset characteristics. The economic significance or the magnitude of the effects of the risk retention requirements will also depend on the overall size of the securitization market and the extent to which the requirements could affect access to, and cost of, capital. Below the Commission describes the Commission’s current understanding of the securitization markets that are affected by this proposed rule.

#### a. Size of Securitization Markets

The ABS market is important for the U.S. economy and comprises a large fraction of the U.S. debt market. During the four year period from 2009 to 2012, 31.1 percent of the \$26.8 trillion in public and private debt issued in the United States was in the form of mortgage-backed securities (MBS) or other ABS, and 2.7 percent was in the form of non-U.S. agency backed (private label) MBS or ABS. For comparison, 32.8 percent of all debt issued was U.S.

<sup>248</sup> This assessment assumes that the underlying loan pool characteristics are accurately disclosed, and with sufficient detail for investors to properly assess the underlying risk. Such a scenario would be reflective of the risk retention requirements solving the moral hazard problem that might otherwise result in the obfuscation of intrinsic risks to the ultimate investors.

<sup>247</sup> See appendix A.

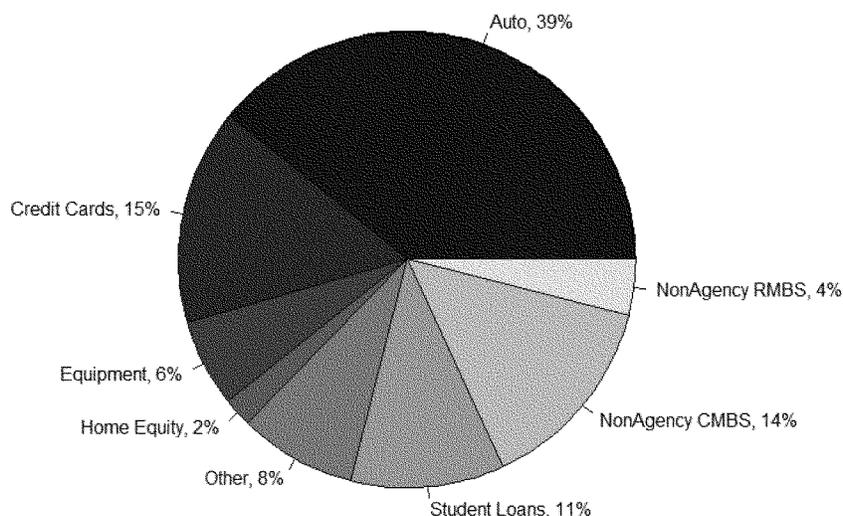
Treasury debt, and 5.7 percent was municipal debt at the end of 2012.<sup>249</sup> Figure 1 shows the percentage breakdown of total non-Agency issuances from 2009 to 2012 for various asset classes excluding asset-backed commercial paper (ABCP) and collateralized loan obligations (CLOs).<sup>250</sup> Consumer credit categories

including automobile and credit card backed ABS comprise 39 percent and 15 percent of the total annual issuance volume, respectively. Non-agency RMBS and commercial mortgage backed securities (CMBS) comprise 4 percent and 18 percent of the market, respectively, while student loan backed ABS account for 11 percent of the

market. Below the Commission analyzes the variation in issuance among these five largest asset classes. For several categories the Commission provides detailed information about issuance volume and the number of active securitizers (Table 2).

FIGURE 1

Non-Agency MBS/ABS issuance in 2009–2012



Source: SIFMA

Prior to the financial crisis of 2008, the number of non-agency RMBS issuances was substantial. For example, new issuances totaled \$503.9 billion in 2004 and peaked at \$724.1 billion in 2005. Non-agency RMBS issuances fell

dramatically in 2008, to \$28.6 billion, as did the total number of securitizers, from a high of 78 in 2007 to 31 in 2008. In 2012, there was only \$15.7 billion in new non-agency RMBS issuances by 13 separate securitizers. Of this amount,

however, only \$3.6 billion was issued by 3 separate securitizers backed by prime mortgages and were not resecuritizations.

TABLE 2—ANNUAL ISSUANCE VOLUME AND NUMBER OF SECURITIZERS BY CATEGORY

Year	Credit card ABS				Automobile ABS				Student loan ABS				Non-agency RMBS			
	SEC	144A	Private	Total	SEC	144A	Private	Total	SEC	144A	Private	Total	SEC	144A	Private	Total
<i>Panel A—Annual Issuance Volume by Category (\$ bn)</i>																
2004	46.3	4.9	0.0	51.2	63.4	6.5	0.0	70.0	38.3	7.5	0.2	45.9	490.3	13.6	0.0	503.9
2005	61.2	1.8	0.0	62.9	85.1	8.7	0.0	93.9	54.1	8.1	0.4	62.6	707.9	16.2	0.0	724.1
2006	60.0	12.5	0.0	72.5	68.0	12.2	0.0	80.2	54.9	10.9	0.5	66.2	702.8	20.4	0.0	723.3
2007	88.1	6.4	0.0	94.5	55.8	6.8	0.0	62.6	41.7	16.0	0.6	58.3	598.1	42.2	0.0	640.3
2008	56.7	5.0	0.0	61.6	31.9	5.6	0.0	37.6	25.8	2.4	0.0	28.2	12.2	16.4	0.0	28.6
2009	34.1	12.5	0.0	46.6	33.9	15.4	0.0	49.2	8.3	12.5	0.0	20.8	0.3	47.8	0.0	48.1
2010	5.3	2.1	0.0	7.5	38.0	15.3	0.0	53.3	2.8	16.2	1.2	20.2	0.2	46.1	12.8	59.2
2011	10.0	4.8	1.5	16.3	41.9	14.4	0.0	56.3	2.5	13.9	1.1	17.5	0.7	11.1	10.5	22.2
2012	28.7	10.5	0.0	39.2	65.6	13.9	0.0	79.5	6.6	23.2	0.0	29.9	1.9	12.6	1.2	15.7
<i>Panel B—Annual Number of Securitizers by Category</i>																
2004	12	4	0	15	29	9	0	37	10	7	1	16	41	15	0	44

<sup>249</sup> Source: SIFMA.

<sup>250</sup> To estimate the size and composition of the private-label securitization market the Commission uses the data from Securities Industry and Financial

Markets Association (SIFMA) and AB Alert. In the following analysis, the Commission excludes all securities guaranteed by U.S. government agencies. ABCP is a short-term financing instrument and is

frequently rolled over, thus, its issuance volume is not directly comparable to the issuance volume of long-term ABS of other sectors. The Commission does not have CLO issuance data.

TABLE 2—ANNUAL ISSUANCE VOLUME AND NUMBER OF SECURITIZERS BY CATEGORY—Continued

Year	Credit card ABS				Automobile ABS				Student loan ABS				Non-agency RMBS			
	SEC	144A	Private	Total	SEC	144A	Private	Total	SEC	144A	Private	Total	SEC	144A	Private	Total
2005 .....	13	5	0	17	30	9	0	38	13	7	1	19	46	18	0	51
2006 .....	10	11	0	18	23	12	0	30	8	17	1	24	50	27	0	62
2007 .....	12	8	0	16	23	9	0	28	7	17	1	22	46	32	0	59
2008 .....	9	3	0	11	16	7	0	20	3	6	0	8	12	19	0	24
2009 .....	9	6	0	11	13	13	0	22	3	6	0	6	1	16	0	17
2010 .....	5	5	0	9	19	15	0	27	2	18	1	19	1	18	1	20
2011 .....	5	7	1	12	14	16	0	25	1	19	1	20	1	12	2	14
2012 .....	7	9	0	13	18	24	0	36	1	26	0	26	1	11	1	12

**Notes:** The numbers in the table were calculated by DERA staff using the AB Alert database. The deals are categorized by offering year, underlying asset type, and offering type (SEC registered offerings, Rule 144A offerings, or traditional private placement). Non-agency RMBS include residential, Alt-A, and subprime RMBS. Automobile loan ABS include ABS backed by automobile loans, both prime and subprime, motorcycle loans, and truck loans). Panel A shows the total issuance amount in billions of dollars. Panel B shows the number of unique sponsors of ABS in each category (the number in the column "Total" may not be the sum of numbers in the columns "SEC", "144A" and "Private" because some securitizers may sponsor deals in several categories). Only ABS deals sold in the U.S. and sponsors of such deals are counted.

Similar to the market for non-agency RMBS, the market for CMBS also experienced a decline following the financial crisis. There were \$229.2 billion in new issuances at the market's peak in 2007.<sup>251</sup> New issuances fell to \$4.4 billion in 2008 and to \$8.9 billion in 2009. In 2012, there were \$35.7 billion in new CMBS issuances.

TABLE 3—CMBS ISSUANCE (\$BN)

Year	Issuance
2004 .....	93.5
2005 .....	156.7
2006 .....	183.8
2007 .....	229.2
2008 .....	4.4
2009 .....	8.9
2010 .....	22.5
2011 .....	34.3
2012 .....	35.7

**Notes:** Source—SIFMA.

While the ABS markets based on credit cards, automobile loans, and student loans experienced a similar decline in issuances following the financial crisis, the issuance trends in Table 2 indicate that they have rebounded substantially more than the non-agency RMBS and CMBS markets. The automobile loans sector currently has the largest issuance volume and the largest number of active sponsors of ABS among all asset classes. There were \$79.5 billion in new automobile ABS issuances in 2012 from 42 securitizers. This amount of new issuances is approximately twice the amount of new issuances in 2008 (\$37.6 billion) and is similar to the amount of new issuances from 2004 to 2007.

<sup>251</sup> See Table 3. The estimates relating to the CMBS market are from SIFMA, and can be found at <http://www.sifma.org/research/statistics.aspx>. The SIFMA dataset does not include information relating to the number of CMBS securitizers and does not distinguish issuances by type.

Although the amount of new credit card ABS issuances has not fully rebounded from pre-crisis levels, it is currently substantially larger than in recent years. There were \$39.2 billion in new credit card ABS issuances in 2012, a five-fold increase over the amount of new issuances in 2010 (\$7.5 billion). The number of credit card ABS securitizers has remained steady over time, totaling 16 in 2012. The amount of new student loan issuances has also not fully rebounded from pre-crisis levels. There were \$29.9 billion in new student loan ABS issuances in 2012, compared to a range from \$45.9 billion to \$58.3 billion between 2004 and 2007. However, the number of student loan securitizers has returned to pre-crisis levels, totaling 27 in 2012. While risk retention requirements will apply to the previous asset classes there are other asset classes not listed here to which risk retention will also apply.

Information describing the amount of issuances and the number of securitizers in the ABCP and CLO markets is not readily available, however, information on the total amount of issuances outstanding indicates that the ABCP market has decreased since the end of 2006, when the total amount outstanding was \$1,081.4 billion, 55 percent of the entire commercial paper market.<sup>252</sup> As of the end of 2012, there were \$319.0 billion of ABCP outstanding, accounting for 30 percent of the commercial paper market.

<sup>252</sup> Based on information from the Federal Reserve Bank of St. Louis FRED Economic Data database.

TABLE 4—COMMERCIAL PAPER (CP) OUTSTANDING (\$BN)

Year	ABCP	All CP outstanding	ABCP share (percent)
2004 ..	688.9	1,401.5	49.2
2005 ..	860.3	1,637.5	52.5
2006 ..	1,081.4	1,974.7	54.8
2007 ..	774.5	1,785.9	43.4
2008 ..	734.0	1,681.5	43.7
2009 ..	487.0	1,170.0	41.6
2010 ..	348.1	971.5	35.8
2011 ..	328.8	959.3	34.3
2012 ..	319.0	1,065.6	29.9

**Notes:** Source—Federal Reserve.

#### b. Current Risk Retention Market Practices

As noted earlier, the potential economic effects of the proposed risk retention requirements will depend on current market practices. Currently, risk retention is not mandated in any sector of the U.S. ABS market, although some sponsors of different ABS classes do retain risk voluntarily—at least at initial issuance. The aggregate levels of current risk retention vary across sponsors and ABS asset classes. Adopted practices are different for different sectors (to the extent that they are applied at all) and there is no uniform reporting of the types or amounts of retained ABS pieces. Because aggregated quantitative information relating to the current risk retention practices of ABS securitizers is currently unavailable, the Commission does not have sufficient information to measure the extent to which risk is currently retained. Below the Commission describes current risk retention practices for various asset classes based upon its understanding of these markets and public comment received to date. The Commission would benefit from additional public comment and data about historical and

current risk retention practices in all ABS sectors.

#### i. RMBS Risk Retention Practices

The Commission understands that securitizers of non-agency RMBS historically did not generally retain a portion of credit risk.<sup>253</sup> Consequently, except in the case where exemptions are applicable (e.g., the QRM exemption), the proposed risk retention requirements likely will impose new constraints on these securitizers.

The Commission also understands that securitizers of other ABS market sectors typically retain some portion of credit risk. For these securitizers, depending on the amount and form of risk currently retained, the proposed risk retention requirements may pose less of a constraint. Markets where securitizers typically retain some portion of risk include the markets for CMBS, automobile loan ABS, ABS with a revolving master trust structure, and CLOs. The markets for CMBS and ABCP include structures in which parties involved in the securitization other than the securitizer retain risk.

#### ii. CMBS Risk Retention Practices

The current risk retention practice in the CMBS market is to retain at issuance the “first loss piece” (riskiest tranche). This tranche is typically sold to a specialized category of CMBS investors, known as a “B-piece buyer”. The B-piece investors in CMBS often hold dual roles as bond investors, if the assets remain current on their obligations, and as holders of controlling interests to appoint special servicers, if the loans default and go into special servicing. As holders of the controlling interest, they will typically appoint an affiliate as the special servicer. The B-piece CMBS investors are typically real estate specialists who use their extensive knowledge about the underlying assets and mortgages in the pools to conduct extensive due diligence on new deals.<sup>254</sup> The B-pieces are often “buy-and-hold” investments, and secondary

<sup>253</sup> However, more recently, one of the largest sponsors of SEC-registered RMBS has stated it currently retains some interest in the RMBS transactions that it sponsors. For example, see Sequoia Mortgage Trust 2013-1, 424b5, File No. 333-179292-06 filed January 16, 2013; [http://www.sec.gov/Archives/edgar/data/1176320/000114420413002646/v332142\\_424b5.htm](http://www.sec.gov/Archives/edgar/data/1176320/000114420413002646/v332142_424b5.htm).

<sup>254</sup> CMBS have a much smaller number of underlying loans in a pool (based on data from ABS prospectuses filed on EDGAR, a typical CMBS has about 150 commercial properties in a pool, whereas RMBS have about 3,000 assets in a pool and automobile loan/lease ABS typically have 75,000 assets) and these loans are often not standardized. Thus, direct management of individual underperforming loans is often necessary and is much more viable for CMBS than for other asset classes.

markets for B-pieces are virtually non-existent at this time.<sup>255</sup> Currently, the B-piece (as defined by Standard & Poor’s) typically makes up the lowest rated 3–4 percent of the outstanding amount of interests issued in CMBS securitization at issuance. During the four year period from 2009 to 2012, the non-rated and all speculative grade tranches typically bought by B-piece buyers made up the lowest 4.4 percent.<sup>256</sup> Thus, the prevailing market practice for risk retention in the CMBS sector is less than the proposed 5 percent B-piece risk retention option for CMBS sponsors.

#### iii. Master Trusts Risk Retention Practices

Securitizers of revolving master trusts often maintain risk exposures through the use of a seller’s interest which, as discussed above, is intended to be equivalent to the securitizer’s interest in the receivables underlying the ABS. The Commission does not have sufficient aggregated data about revolving master trusts that would permit it to estimate the amount of risk currently retained. The Commission requests comment for this below.

#### iv. Other ABS Risk Retention Practices

The current voluntary market practices for other categories of ABS that serve to align the interests of the sponsor and investors vary across asset classes. The Commission understands that securitizers of automobile loan ABS typically maintain exposure to the quality of their underwriting by retaining ABS interests from their securitization transactions; however, there is insufficient data available to the Commission to estimate the equivalent amount of risk retained through this practice. The Commission understands that securitizers of student loans do not typically retain credit risk. However, Sallie Mae, the largest sponsor of student loan asset-backed securities, does retain a residual interest in the securitizations that it sponsors.

#### vi. ABCP Risk Retention Practices

Commenting on the original proposal, ABCP conduit operators noted that there are structural features in ABCP that align the interests of the ABCP conduit sponsor and the ABCP investors. For instance, ABCP conduits usually have

<sup>255</sup> An industry publication places the number of active B-piece buyers in 2007 at 12, and the number of active B-piece buyers between 2010 and the first part of 2011 at 1. This information was taken from S&P Credit Research. “CMBS: The Big ‘B’ Theory” Apr 11, 2011, <https://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245302231520>.

<sup>256</sup> DERA staff calculated these numbers using data from Standard & Poor’s RatingsXpress.

some mix of credit support and liquidity support equal to 100 percent of the ABCP outstanding. This liquidity and credit support exposes the ABCP conduit sponsor to the quality of the assets in an amount that far exceeds 5 percent.

#### vi. CLO Risk Retention Practices

Some commenters noted that securitizers of CLOs often retain a small portion of the residual interest and asserted that securitizers retain risk through subordinated management and performance fees that have performance components that depend on the performance of the overall pool or junior tranches. The proposed rule does not allow for fees to satisfy risk retention requirements. The Commission is requesting comment on any recent developments in the CLO market whereby risk is retained as defined by the proposed rule.<sup>257</sup>

#### 4. Analysis of Risk Retention Requirements

As discussed above, the agencies are proposing rules to implement Section 15G of the Exchange Act requiring sponsors of asset backed securitizations to retain risk. Each of the asset classes subject to these proposed rules have their own particular structure and, as a result, the implementation and impact of risk retention will vary across asset classes, although certain attributes of risk retention are common to all asset classes. In this section, the Commission discusses those aspects of the proposed rules that apply across asset classes: The requirement that securitizers hold 5 percent of the credit risk of a securitization, the use of fair value (versus par value) of the securitization as the method of measuring the amount of risk retained by the securitizer, and the length of time that a securitizer would be required to hold its risk exposure.

<sup>257</sup> In the Board of Governors of the Federal Reserve System’s “Report to the Congress on Risk Retention” (October 2010), pp. 41–48, mechanisms intended to align incentives and mitigate risk are described, including alternatives such as overcollateralization, subordination, guarantees, representations and warranties, and conditional cash flows as well as the retention of credit risk. The Report also contains a description of the most common incentive alignment and credit enhancement mechanisms used in the various securitization asset classes. The Report does not establish the extent to which these alternatives might be substitutes for the retention of credit risk.

a. Level and Measurement of Risk Retention

i. Requirement To Hold Five Percent of Risk

Section 15G requires the agencies to jointly prescribe regulations that require a securitizer to retain not less than 5 percent of the credit risk of any asset that the securitizer, through the issuance of ABS, transfers, sells, or conveys to a third party, unless an exemption from the risk retention requirements for the securities or transaction is otherwise available. The agencies are proposing to apply a minimum 5 percent base risk retention requirement to all ABS transactions that are within the scope of Section 15G.

As a threshold matter, the requirement to retain risk is intended to align the incentives of the ABS sponsors and their investors. Sponsors of securitizations should be motivated to securitize assets with probabilities of default that are accurately reflected in the pricing of the corresponding tranches, because they will be required to hold some of the risk of the assets being securitized. Risk retention may increase investor participation rates because investors would have assurance that the sponsor is exposed to the same credit risk and will suffer similar losses if default rates are higher than anticipated. This may increase borrower access to capital, particularly if loan originators are otherwise constrained in their ability to underwrite mortgages because more investors means more available capital. In particular, the act of securitizing the loans allows the lenders to replenish their capital and continue to make more loans, over and above what could be made based solely on the initial capital of the lender. When the underlying risks are disclosed properly, securitization should facilitate capital formation as more money will flow to borrowers. Higher investment may also lead to improved price efficiency, as the increase in securitization transactions will provide additional information to the market.

While risk retention is intended to result in better incentive alignment, it is important to consider whether a 5 percent risk retention requirement will appropriately align the incentives of the sponsors and investors. Establishing an appropriate risk retention threshold requires a tradeoff between ensuring that the level of risk retained provides adequate incentive alignment, while avoiding costs that are associated with restricting capital resources to projects that may offer lower risk-adjusted returns. A risk retention requirement that is set too high could lead to

inefficient deployment of capital as it would require the capital to be retained rather than further used in the market to facilitate capital formation. On the other hand, a risk retention requirement that is too low could provide insufficient alignment of incentives.

In certain cases the agencies have proposed to exempt asset classes from the risk retention requirements because there already exists sufficient incentive alignment or other features to conclude that further constraints are unnecessary. In particular, the securitizations of these exempted asset classes have characteristics that ensure that the quality of the assets is high. For example, if the pool of assets sponsors can securitize is drawn from an asset class with a low probability of default, opportunities to exploit potentially misaligned incentives are fewer and investors may have a correspondingly lesser need for the protection accorded by risk retention requirements.

Another possibility is that excessive required risk retention levels may prevent capital from being used in more valuable opportunities, leading to potentially higher borrowing rates as capital is diverted to required risk retention. In this scenario the reduction in capital formation would have a negative impact on competition due to the extra cost of securitizing non-qualified assets, disadvantaging them relative to qualified assets. However, the statute prescribes a 5 percent minimum amount of risk be retained.

ii. Measurement of Risk Retention Using Fair Value

The agencies have proposed to require sponsors to measure risk retention using a fair value framework as described in U.S. GAAP (ASC 820). The Commission believes that this would align the measurement more closely with the economics of a securitization transaction because market valuations more precisely reflect the securitizer's underlying economic exposure to borrower default. Defining a fair value framework also may enhance comparability across different securitizations and provide greater clarity and transparency.

Use of fair value accounting as a method of valuing risk retention also will provide a benefit to the extent that investors and sponsors can understand how much risk is being held and that the valuation methodology accurately reflects intrinsic value. If investors cannot understand the proposed measurement methodology, the value of holding risk will be reduced as investors will be unable to determine the extent to which risk retention aligns

incentives. If investors cannot determine whether incentives are properly aligned, they may invest less in the securitization market because there will be uncertainty over the quality of assets being securitized.

One benefit of fair value is investors and sponsors generally have experience with fair value accounting. In addition, the use of fair value is intended to prevent sponsors from structuring around risk retention.

Fair value calculations are susceptible to a range of results depending on the key variables selected by the sponsor in determining fair value. This could result in costs to investors to the extent that securitizers use assumptions resulting in fair value estimates at the outer edge of the range of potential values, and thereby potentially lowering their relative amount of risk retention. In order to help mitigate this potential cost, the agencies have proposed to require the sponsor to disclose specified information about how it calculates fair value. While this requirement should discourage manipulation, sponsors will incur additional costs to prepare the necessary disclosures. In addition, because the proposed rule specifies that fair value must be determined by fair value framework as described in US GAAP, sponsors will incur costs to ensure that the reported valuations are compliant with the appropriate valuation standards.

Alternatively, the agencies could have proposed to require risk retention be measured using the par value of the securitization, as in the original proposal. Par value is easy to measure, transparent, and would not require any modeling or disclosure of methodology. However, holding 5 percent of par value may cause sponsors to hold significantly less than 5 percent of the risk because the risk is not spread evenly throughout the securitization. In addition, not all securitizations have a par value. Another alternative considered was premium capture cash reserve account (PCCRA) plus par value. The agencies took into consideration the potential negative unintended consequences the premium capture cash reserve account might cause for securitizations and lending markets. The elimination of the premium capture cash reserve account should reduce the potential for the proposed rule to negatively affect the availability and cost of credit to consumers and businesses.

b. Duration of the Risk Retention Requirement

Another consideration is how long the sponsor is required to retain risk. For example, most of the effects of poor

underwriting practices likely would be evident in the earlier stages of a loan's life. If the risk is retained for longer than is optimal, there may be a decrease in capital formation because capital cannot be redeployed to more efficient uses, resulting in higher costs to securitizers than necessary. On the other hand, if the risk is not retained long enough, risk retention will not mitigate the incentive misalignment problem. The optimal duration of the risk retention requirement will in large part depend on the amount of time required for investors to realize whether the risks of the underlying loan pools were accurately captured, which may vary across asset classes. For instance, short durations relative to maturity may be appropriate for asset classes where a significant fraction of the defaults occur at the beginning of the loan life cycle, such as in the case with RMBS, while longer durations are more appropriate for asset classes where performance takes longer to evaluate, such as with CMBS, where performance may not be assessed until the end of the loan.

To the extent that there exists a window where risk retention is needed but dissipates once the securitization is sufficiently mature, requiring a sponsor to retain risk beyond this window could be economically inefficient. Consequently, the proposal includes a sunset provision whereby the sponsor is free to hedge or transfer the retained risk after a specified period of time. Allowing the risk retention requirement to sunset will eventually free up capital that can be redeployed elsewhere in the business, thereby helping to promote capital formation.

In certain instances where the sponsor is the servicer of the loan pool, the sunset provision may motivate the sponsor to delay the recognition of defaults and foreclosures until after the sunset provision has lapsed. The sponsor's incentive to delay arises from its credit exposure to the pool and its control over the foreclosure process. Thus, the sponsor/servicer may extend the terms of the loans until the expiration of the risk retention provision.<sup>258</sup> To the extent that sponsors delay revealing borrowers' non-performance, this would decrease economic efficiency and impair pricing transparency.

For RMBS, the agencies have proposed to require securitizers to retain risk for the later of five years or until the pool balance has been reduced to 25

percent (but no longer than seven years). For all other asset classes, the agencies have proposed to require securitizers to retain risk for the later of two years or until the pool balance has been reduced to 33 percent. These methods were chosen to balance the tradeoff between retaining risk long enough to align the sponsors and investors incentives and allowing the redeployment of retained capital for other productive uses. A shorter duration was chosen for non-mortgage asset classes, because these loans tend to have shorter maturities than mortgages. Requiring a two year holding period recognizes that it may not be necessary to retain risk for a longer period. The alternative component further calibrates the required duration of risk retention based on the remaining balances. By the time the loan pool balance decreases to 33 percent, the information about the loan performance will be largely revealed, at which point the moral hazard problem between the sponsor and the investor is likely to be significantly reduced. Although, in the case where the loan pool balance drops below the prescribed threshold (25 percent for RMBS and 33 percent for other ABS) before the prescribed number of years (five years for RMBS and two years for other ABS), the additional required duration might be costly to the sponsor. In other words, requiring the securitizer to continue to retain exposure to the securitization, once impact of the information asymmetry has been significantly reduced, would impose unnecessary costs, potentially impeding allocation efficiency. Indeed, as currently proposed, as loan balances are paid down the sponsor may hold more risk relative to other investors because the size of the credit risk retention piece is based on the initial size of the securitization, and does not change with the current market value. This heightened level of risk retention may be unnecessary, because at that point, there is nothing further the sponsor can do to adversely impact investors, so that economic efficiency would be better served by allowing securitizers to withdraw their risk retention investment to utilize in new securitizations or other credit forming activities.<sup>259</sup>

<sup>259</sup> See Hartman-Glaser, Piskorski and Tchisty (2012). In order to achieve the economic goals of the risk retention requirement, it should be the case that the moral hazard and information asymmetry between the securitizer and the investors would be fully resolved by the time that loan balances are reduced to 25 percent (in the case of RMBS) or 33 percent (in all other asset classes). The Commission is unaware of any empirical studies or evidence that supports such a conclusion.

## 5. Blended Pools and Buyback Provision

### a. Blended Pools

Blended pools are pools that consist of assets of the same class, some of which qualify for an exemption from the risk retention requirement, and some of which do not qualify for an exemption from the risk retention requirement. The proposed rule permits proportional reduction in required risk retention for blended pools that consist of both exempted and non-exempted assets. The proposed rule does not allow mixing asset classes in the same pool for the purpose of reduction of the risk retention requirement and has several other restrictions to reduce potential of structuring deals around the risk retention requirement. Allowing blended pools with a reduced risk retention requirement will improve efficiency, competition and capital formation by allowing sponsors to securitize more loans when it is difficult to obtain a large enough pool of qualifying assets to issue an ABS consisting entirely of exempted assets.

### b. Buyback Requirement

The proposal requires that, if after issuance of a qualifying asset securitization, it was discovered that a loan did not meet the qualifying underwriting criteria, the sponsor would have to repurchase or cure the loan (the "buyback requirement"). The buyback provision increases investors' willingness to invest because it makes sponsors of an ABS responsible for correcting discovered underwriting mistakes and ensures that the actual characteristics of the underlying asset pool conform to the promised characteristics.

## 6. Forms of Risk Retention Menu of Options

Rather than prescribe a single form of risk retention, the proposal allows sponsors to choose from a range of permissible options to satisfy their risk retention requirements. As a standard form of risk retention available to all asset classes, sponsors may choose vertical risk retention, horizontal risk retention, or any combination of those two forms. All of these forms require the sponsor to share the risk of the underlying asset pool. The proposal also includes options tailored to specific asset classes and structures such as revolving master trusts, CMBS, ABCP and CLOs. Given the special characteristics of certain asset classes, some of these options permit the sponsor to allocate a portion of the shared risk to originators or specified third parties.

<sup>258</sup> Yingjin Hila Gan and Christopher Mayer. Agency Conflicts, Asset Substitution, and Securitization. NBER Working Paper No. 12359, July 2006.

By proposing to allow sponsors flexibility to choose how they retain risk, the agencies' proposal seeks to enable sponsors to select the approach that is most effective. Various factors are likely to impact the securitizers preferred method of retaining risk, including size, funding costs, financial condition, riskiness of the underlying assets, potential regulatory capital requirements, income requirements, risk tolerances and accounting conventions. All else being equal, sponsors may prefer the option that involves the least exposure to credit risk. For example, the horizontal form of standard risk retention essentially creates a fully subordinated equity tranche and represents the option that is most exposed to credit risk. By contrast, a vertical form of standard risk retention is comparable to a stand-alone securitization that is held by the sponsor and, among the available options, is the least exposed to credit risk. Some sponsors may choose to utilize the horizontal method of risk retention or some combination of the horizontal and vertical method in order to meet the risk retention requirement, while at the same time signaling the market that the sponsor is securitizing better quality assets.

If investors believe that the sponsor's choice of risk retention method results in insufficient risk exposure to properly align incentives, the proposed optionality may result in less effective risk retention. However, because investors can observe this choice to help inform their investment decision, sponsors have incentive to choose the level of risk exposure that encourages optimal investor participation. That is, investors may be more likely to participate if the sponsor has more skin in the game, which may lead sponsors to prefer an option with a higher level of risk retention. Alternatively if the sponsor retains insufficient risk exposure investors may not perceive this as a sufficient alignment of interest and may not invest (*i.e.*, sponsors may securitize bad assets if they do not have enough exposure).

As the Commission discusses below, a number of the options also correspond to current market practices. By allowing sponsors to satisfy their risk retention requirement while still maintaining current market practices the proposed menu of options approach should help to reduce costs of the required regime. Moreover, the flexibility sponsors have to design how they prefer to be exposed to credit risk will allow them to calibrate and adjust their selections according to changing market conditions. It also will accommodate

evolving market practices as securitizers and investors update preferences and beliefs.

#### a. Standard Risk Retention

The standard form of risk retention would permit sponsors to choose vertical risk retention, horizontal risk retention, or any combination of these two forms.

#### i. Eligible Horizontal Residual Interest

One way that a sponsor may satisfy the standard risk retention option is by retaining an "eligible horizontal residual interest" in the issuing entity in "an amount that is equal to at least 5 percent of the fair value of all ABS interests in the issuing entity that are issued as part of the securitization transaction."<sup>260</sup> The proposed rules include a number of terms and conditions governing the structure of an eligible horizontal residual interest in order to ensure that the interest would be a "first-loss" position, and could not be reduced in principal amount (other than through the absorption of losses) more quickly than more senior interests and, thus, would remain available to absorb losses on the securitized assets.

This option may provide sponsors with an incentive to securitize safer assets relative to other risk retention options because they hold the first loss piece. If sponsors are restricted to only holding risk retention through the horizontal form, they may choose to reduce their credit exposure by issuing relatively safe loans. This would possibly restrict the amount of capital available for riskier but viable loans. Alternatively, investors could require higher loan rates to compensate for this risk.

A number of commenters on the original proposal generally believed that the retention of a subordinated interest effectively aligns the incentives of ABS sponsors with ABS investors. Another commenter stated that in prime RMBS securitizations, where there is no overcollateralization, a horizontal slice would be the best approach. Horizontal risk retention may improve capital formation to the extent it makes investors more willing to invest in the securitization markets.

It is not clear that horizontal risk retention will fully align sponsor incentives with investor incentives. Investors who are investing in the most senior tranches will have different incentives than the sponsor who is holding the equity tranche. This is similar to debt/equity issues that exist

in the corporate bond market. Several commentators expressed concerns regarding the horizontal risk retention option. These commentators noted that the retention of a subordinated tranche by the sponsor has the potential to create substantial conflicts of interest between sponsors and investors. Another commentator recommended that the final rules remove horizontal as an option in RMBS transactions noting that history has already shown that retaining the equity tranche was not enough to align the securitizer's incentives with those of investors in the securitization's other tranches.

#### ii. Eligible Vertical Interest

Another way a sponsor may satisfy the standard risk retention option is by retaining at least 5 percent piece of each class of interests issued in the transaction or a single vertical security. The proposed rules also would require a sponsor that elects to retain risk through the vertical form of standard risk retention to disclose to potential investors and regulators certain information about the retained risks and the assumptions and methodologies used to determine the aggregate dollar amount of ABS interests issued. The vertical form of standard risk retention aligns incentives of the sponsor with every tranche in the securitization by requiring the sponsor to hold a percentage of each tranche. Several commentators on the original proposal noted that the vertical form of standard risk retention was easy to calculate, more transparent and less subject to manipulation. Commenters also noted that the vertical form of standard risk retention would receive better accounting treatment than the horizontal form of standard risk retention. In addition, one of these commenters noted that because managed structures, including CDOs, have compensation structures that incentivize managers to select riskier, higher yielding assets to maximize return and equity cash flows, the vertical form of standard risk retention is the only option that incentivizes managers to act for the benefit of all investors.

More generally, by allowing sponsors to choose a vertical form of risk retention, there will be increased flexibility to choose higher yielding assets and provide greater access to capital to viable but higher risk borrowers than what would otherwise be possible through only a horizontal form of risk retention. While the single vertical security will have similar costs and benefits to holding 5 percent of each tranche, there are slight

<sup>260</sup> Stated as an equation: The EHRI amount  $\geq 5\%$  of the fair value of all ABS interests.

differences. The main difference is that the single vertical security trading costs may be lower than the costs of buying 5 percent of each tranche.

Alternatively, the agencies considered allowing for loan participations as an option that commenters raised that would satisfy the risk retention requirements. Ultimately, it was determined that there would be little to no economic benefit for allowing this option because the option is currently not used by the market and would unlikely be used.

### iii. L-Shaped Risk Retention

As discussed above, the horizontal and vertical risk retention options each present certain costs to securitizers. It is possible that potential sponsors of securitizations would find both of these risk retention options costly. The original risk retention proposal included an option of combining equal parts (2.5 percent) of vertical and horizontal risk retention. While this combination of horizontal and vertical risk retention may mitigate some of the costs related to the horizontal only or vertical only risk retention options, it is possible that combinations other than equal parts would also satisfy the objectives of the risk retention requirements. Hence, in an effort to provide greater flexibility to sponsors, the agencies are proposing to permit sponsors to hold any combination of vertical and horizontal risk retention. The benefit of this flexibility is that the approach allows sponsors to minimize costs by selecting a customized risk retention method that suits their individual situation and circumstance, including relative market demand for the various types of interest that may be retained under the rule. To the extent that the costs and benefits of credit risk retention vary across time, across asset classes, or across sponsors, this approach would implement risk retention in the broadest possible manner such that sponsors may choose the risk retention implementation that they view as optimal. This approach may also permit sponsors some flexibility with regard to structuring credit risk retention without having to consolidate assets.

The proposed set of risk retention alternatives would provide sponsors with a much greater array of credit risk retention strategies to choose from. Because sponsors are given the choice on how to retain risk, their chosen shape may not be as effective in aligning interests and mitigating risks for investors. That is, it may create fewer benefits or more costs for investors than other alternatives might. Thus, the standard risk retention option, to the

extent that different percentages of horizontal and vertical risk retention create disparate benefits and costs for sponsors and investors, may perpetuate some of the conflicts of interest that characterized prior securitizations. This approach, may create flexibility, but may also increase the complexity of implementation of risk retention and the measurement of compliance due to the wide choices sponsors would enjoy.

Horizontal risk retention allows sponsors to communicate private information about asset quality more efficiently, in some cases, than vertical risk retention, but only if both forms of risk retention are an option. A sponsor choosing to retain risk in a horizontal form over a vertical form may be able to signal to the market that the sponsor's incentives are better aligned with investors'. By choosing a costlier way of retaining risk, such as the horizontal form, a sponsor can signal to the market the high quality of their assets. This provides a benefit to sponsors who are able to signal the high quality of their assets less costly than retaining risk in the vertical form and using another signaling mechanism.

Alternatively, the agencies considered allowing sponsors to retain risk through holding a representative sample of the loans being securitized as proposed in the original proposal. The option was not included, among other reasons, because of, as noted by commenters, its difficulty to implement.

### b. Options for Specific Asset Classes and Structures

#### i. Master Trust

Securitizations of revolving lines of credit, such as credit card accounts or dealer floor plan loans, are typically structured using a revolving master trust, which issues more than one series of ABS backed by a single pool of revolving assets. The proposed rule would allow a sponsor of a revolving master trust that is collateralized by loans or other extensions of credit to meet its risk retention requirement by retaining a seller's interest in an amount not less than 5 percent of the unpaid principal balance of the pool assets held by the sponsor.

The definitions of a seller's interest and a revolving master trust are intended to be consistent with current market practices and, with respect to seller's interest, designed to help ensure that any seller's interest retained by a sponsor under the proposal would expose the sponsor to the credit risk of the underlying assets. Commenters on the original proposal supported permitting a sponsor to satisfy its risk

retention requirement through retention of the seller's interest. In this regard, a trade association commented that the seller's interest, in essence, represents a vertical slice of the risks and rewards of all the receivables in the master trust, and therefore operates to align the economic interests of securitizers with those of investors. In contrast, many commenters raised structural (or technical) concerns with the proposed master trust option.

The Commission preliminarily believes that aligning the requirements with current market practice will balance implementation costs for sponsors utilizing the master trust structure with the benefits that investors receive through improved selection of underlying assets by the sponsors. Maintaining current practice will be transparent and easy for the market to understand and will preserve current levels of efficiency and maintain investor's willingness to invest in the market. Codification of current practice will also provide clarity to market participants and may encourage additional participation given the removal of previous uncertainty about potential changes to current practices, thereby increasing capital formation.

Under this option, there would be a cost to sponsors of measuring and disclosing the seller's interest amount on an ongoing basis, but since this is a current market practice, the additional cost should be minimal. The agencies propose requiring the 5 percent seller's interest to be measured in relation to the fair value of the outstanding investors' interests rather than the principal amount of assets of the issuing entity. As discussed above this acts to make sure the sponsors' incentives are aligned with the borrower and to make sure the holdings of the sponsor are enough to economically incentivize them.

#### ii. CMBS

The Commission understands that the current market practice regarding risk retention in the CMBS market is largely in line with the agencies' proposed rules. The proposed rules allow for the continuation of current risk retention market practice for CMBS in the form of the B-piece retention with additional modifications to the current practice. Under the agencies' proposal, a sponsor could satisfy the risk retention requirements by having up to two third-party purchasers (provided that each party's interest is *pari passu* with the other party's interest) purchase an eligible horizontal residual interest (B-piece) in the issuing entity if at least 95 percent of the total unpaid principal balance is commercial real estate loans.

The third-party purchaser(s) would be required to acquire and retain an eligible horizontal residual interest in the issuing entity in the same form, amount, and manner as the sponsor (with the same hedging, transfer and other restrictions) except that after five years the third-party purchaser can sell the B-piece to another eligible third-party purchaser. Giving the third-party purchaser the ability to sell the B-piece to another qualified third-party purchaser should not affect the costs or benefits as the transference of the B-piece keeps the structure of the ABS intact and therefore the alignment of incentives will not change. The original third-party purchaser benefits by being given more liquidity and making the purchase of the B-piece not as costly, encouraging eligible B-piece purchasers to purchase the B-piece and increasing competition among B-piece purchasers. The sponsor would be responsible for monitoring the B-piece buyer's compliance with the preceding restrictions, and an independent operating advisor with the authority to call a vote to remove the special servicer would be appointed.

The proposed option would not allow for B-pieces to be further packaged into other securitizations such as CDOs. Due to the current limited state of the CDO market, to the extent the proposal is codifying the current state of the market, there may be costs and benefits to market perception that the Commission cannot quantify but relative to the current state there are no costs and benefits. However, to be consistent with the motivation behind the proposed rule, prohibiting repackaging of B-pieces incentivizes sponsors to exercise the oversight necessary to align interests.

Consistent with the current practice that the "B-piece" is the lowest rated tranche(s) of CMBS (most junior tranche), it accepts the first losses in the case of defaults, and, thus, it is equivalent to the horizontal ("first-loss") option of the general risk retention rule applied to CMBS. Consequently, the costs and benefits of the "B-piece" are similar to the ones for the horizontal form of standard risk retention. To the extent that sponsors would continue the current market practice that they voluntarily use, the costs and benefits will be marginal (since the rule proposes mandating the size of a B-piece at the level similar to, although slightly higher than, the currently used) with the exception below.

Under current market practice, B-piece investors (who are often also special servicers) have a conflict of interest with investment grade tranche

investors. This conflict could persist to the extent that CMBS sponsors choose to structure their risk retention consistent with current practice. In theory, a (special) servicer must try to maximize recovery for all tranche holders; however, if the servicer is also the subordinate tranche holder, it may not look after the borrowers' or senior tranche investors' positions, but rather may undertake actions (modification, foreclosure, etc.) that maximize the position of the first-loss investors at the expense of borrowers or senior tranche investors.<sup>261</sup> While this potential conflict of interest may continue to exist, depending on how the sponsor structures the risk retention, the proposed rules include requirements that may lessen the impact of the conflict.

The proposed rule requires appointment of an independent operating advisor who, among other obligations, has the authority to recommend and call a vote for removal of the special servicer under certain conditions. This proposed requirement may serve to limit the adverse effects of the potential conflict of interest, thus helping to ensure that the benefits of the risk retention requirements are preserved. There would be costs, however, related to the appointment of the independent operating advisor, including, but not limited to, the payments to the advisor.

In comparison to the current lack of any statutorily mandated risk retention, the primary benefit of allowing sponsors is to maintain their current market practices, which effectively achieve the intended objectives of risk retention. In a manner analogous to the discussion of horizontal risk retention, the B-piece sale may incentivize the sponsor (through the intended B-piece buyer) to securitize safer assets relative to retaining an eligible vertical interest under the standard risk retention option. To the extent that safer assets are securitized, investors may be more willing to invest in CMBS, thus, increasing the pool of available capital for lending on the commercial real estate market. If only the safest commercial real estate loans are securitized, however, capital formation could potentially be negatively impacted due to sponsors not issuing loans they cannot securitize. Thus,

<sup>261</sup> Yingjin Hila Gan and Christopher Mayer. "Agency Conflicts, Asset Substitution, and Securitization", NBER Working Paper No. 12359, July 2006, and Brent W. Ambrose, Anthony B. Sanders, and Abdullah Yavas. "CMBS Special Servicers and Adverse Selection in Commercial Mortgage Markets: Theory and Evidence", 2008, Working Paper.

riskier loans may not be extended to potentially viable borrowers. Since sponsors can sell the B-piece to specialized investors who are willing to take risk (and able to evaluate and manage it), sponsors can free up additional capital. Thus, allowing the B-piece option may lead to increased capital formation and allocational efficiency because the risk is transferred to those parties that are willing and able to bear it. Both effects could lead to a decline in costs of borrowing for commercial real estate buyers relative to a situation where the B-piece is not permitted.

To the extent that the proposed rule allows the current market practice to continue with minor change in the size of the horizontal piece, and most market participants follow it, both costs and benefits of the proposed rule are expected to be minimal with the exception of the requirement of the appointment of the independent operating advisor discussed above.

### iii. ABCP

The original proposal included a risk retention option specifically designed for ABCP structures. As explained in the original proposal, ABCP is a type of liability that is typically issued by a special purpose vehicle (commonly referred to as a "conduit") sponsored by a financial institution or other sponsor. The commercial paper issued by the conduit is collateralized by a pool of assets, which may change over the life of the entity. Depending on the type of ABCP program being conducted, the securitized assets collateralizing the ABS interests that support the ABCP may consist of a wide range of assets including automobile loans, commercial loans, trade receivables, credit card receivables, student loans, and other loans. Some ABCP conduits also purchase assets that are not ABS interests, including direct purchases of loans and receivables and repurchase agreements. Like other types of commercial paper, the term of ABCP typically is short, and the liabilities are "rolled," or refinanced, at regular intervals. Thus, ABCP conduits generally fund longer-term assets with shorter-term liabilities. In the current market the sponsors of the ABS interests purchased by ABCP conduits often retain credit risk and eventually all sponsors of ABS will be required to comply with the credit risk retention rules.

Under the proposal, sponsors of ABCP conduits could either hold 5 percent of the risk as discussed above using the standard risk retention option or could rely on the ABCP option outlined

below. To the extent that an ABCP conduit sponsor or its majority-owned affiliate already holds over 5 percent of the outstanding ABCP and at least 5 percent of the residual interest in the ABCP conduit, the costs will be minimal. Under the current proposal, ABCP sponsors would be provided an ABCP conduit risk retention option. As long as the assets held in the ABCP conduit are not purchased in the secondary markets and the sponsor of every ABS interest held by the ABCP conduit complies with the credit risk retention requirements then the ABCP conduit sponsor would not be required to retain risk. Because the sponsor of the ABS interest held by the ABCP conduit would need to comply with the credit risk retention requirements certain assets such as receivables would not be eligible for purchase by an eligible ABCP conduit which would incentivize ABCP conduits to hold other assets.

Another condition of the proposed conduit option is the requirement that the ABCP conduit have 100 percent liquidity support and that all ABS held in the conduit are not acquired in secondary market transactions. Limiting an eligible ABCP conduit to holding ABS interests acquired in initial issuances may allow the conduit to negotiate the terms of the deal and have an effect on the riskiness of the ABS interests. This may incentivize ABCP conduits to hold ABS interests acquired in initial issuances over ABS interests acquired in secondary markets, possibly resulting in increased costs in the secondary markets for ABS interests due to lower liquidity and potentially decreasing efficiency in the secondary markets for ABS interests. At the same time, encouraging primary market transactions may increase capital formation as new ABS interests will be necessary for ABCP conduits to issue ABCP. The liquidity support may increase costs for ABCP conduits that were previously unguaranteed or lacked liquidity support that meets the requirements in the proposal.

#### iv. CLOs

Collateralized Loan Obligations (CLO) sponsors are required to retain the same 5 percent of risk as other asset classes. Collateralized loans have longer maturities, implying that loan balances will not decrease much prior to the maturity of the CLO. Under the proposed sunset provisions, this will require the manager to effectively retain risk for the life of the CLO. Longer risk retention periods could help to mitigate concerns that managers may alter the composition of the loan portfolio relative to a short sunset provision. The

agencies consider CLO managers to be the sponsors of CLOs and thus they would be required to meet the credit risk retention requirements. The amount of capital available to managers to hold risk can vary with the size and affiliations of the manager. To the extent that the CLO market has different sized managers, the relative capital costs for managers with a small balance sheet available to service the 5 percent of risk retention will be greater than the capital costs for managers with larger balance sheets. This may induce smaller managers to borrow capital in order to cover holding 5 percent of the risk, which could result in different funding costs between smaller and larger managers. As a result, the CLO option may impact competition by creating an advantage for managers with lower funding costs, and potentially encourage banks to start sponsoring managers. The Commission lacks sufficient information on the distribution of CLO manager characteristics, including their size, access to capital, and funding costs, to be able to assess such an impact.

The agencies are proposing to allow certain types of CLO to satisfy the risk retention requirement if the lead arranger for the underlying loan tranche has taken an allocation of the syndicated credit facility under the terms of the transaction that includes a tranche that is designated as a CLO-eligible loan tranche and such allocation is at least equal to the greater of (a) 20 percent of the aggregate principal balance at origination and (b) the largest allocation taken by any other member (or members affiliated with each other) of the syndication group.

#### v. Enterprises

The proposed rules allow the guarantee of the Enterprises under conservatorship or receivership to count as risk retention for purposes of the risk retention requirements. Because of the capital support provided by the U.S. government for the Enterprises, investors in Enterprise ABS are not exposed to credit loss, and there is no incremental benefit to be gained by requiring the Enterprises to retain risk. This along with the Enterprises' capital support creates a competitive advantage for the Enterprises over private-sector securitizers when purchasing loans.

Reinforcing this competitive advantage will provide three significant consequences. First, recognizing the guarantee of the Enterprises as fulfilling their risk retention requirement will allow them to facilitate the availability of capital to segments of the population that might not otherwise have access through private sector channels. In

particular, without Enterprise programs, borrowers that cannot qualify for loans that are exempt from the risk retention requirements, but could otherwise support repayment of a loan, might not be able to secure a loan if lenders are unwilling or unable to underwrite and retain such loans on their own balance sheet. Second, the recognition of the guarantee of the Enterprises as fulfilling their risk retention requirement will smooth home financing in periods when banks curb their lending due to limited access to capital and private-sector securitizers are unable or unwilling to meet excess demand. Finally, recognizing the guarantee of the Enterprises as fulfilling their risk retention requirement will preserve liquidity in the market for mortgages that are not QRM.

The main cost of recognizing the Enterprises' guarantee as fulfilling their risk retention requirement is the increased probability that they will purchase riskier loans that do not meet the QRM criteria. A riskier loan portfolio may increase the Enterprises' likelihood of default, which has the potential of creating additional taxpayer burden. Some commenters noted that by allowing the guarantee of the Enterprises as fulfilling their risk-retention requirements and preserving their competitive advantage vis-à-vis private securitizers, our rules may result in costs to private securitizers, including perhaps exiting the market because of their inability to favorably compete with the Enterprises. This will have the effect of reducing competition and may impede capital formation in segments of the market not served by the Enterprises. However, analysis of loans originated between 1997 and 2009, a period that spans the onset of the financial crisis, shows that private label loans had a much higher serious delinquency rate than Enterprise purchased loans, even after accounting for different underlying loan characteristics.<sup>262</sup> Hence, this historical performance-based evidence suggest that Enterprise underwriting standards offset any incentive to incur excess risk because of their capital support relative, at least in relation the incentives and behaviors among private label securitizers during the same period. Furthermore, as discussed below, the proposed rule includes a proposal to define QRM, which would lessen the

<sup>262</sup> See Joshua White and Scott Bauguess, *Qualified Residential Mortgage: Background Data Analysis on Credit Risk Retention*, (August 2013), available at <http://www.sec.gov/divisions/riskfin/whitepapers/qrm-analysis-08-2013.pdf>.

potential competitive harm to private securitizers.

#### vi. Alternatives

In developing the proposed rules on the retention of risk required under Section 15G of the Exchange Act, as added by Section 941(b) of the Dodd-Frank Act, the agencies considered a number of alternative approaches. Some of the alternatives were suggested by commenters following the previous rule proposals.

For instance, commenters suggested other forms of risk retention such as: 5 percent participation interest in each securitized asset; for CLOs, a performance fee-based option; loss-absorbing subordinate financing in CMBS (such as “rake bonds”); “contractual” risk retention; private mortgage insurance as a permissible form; overcollateralization; subordination; third-party credit enhancement; and conditional cash flows. The agencies believed that the costs and benefits of these options were not an improvement over the now proposed standard risk retention option. The Commission invites public comment regarding all aspects of the proposed approach and potential alternative approaches.

Alternative amounts of risk retention include: Requiring sponsors to retain a fixed amount of more than 5 percent; Establishing the risk retention percentage depending on asset class; and establishing the risk retention requirement on a sliding scale depending on the (risk) characteristics of the underlying loans observable at origination (*e.g.*, instead of the two level structure of 0 percent for exempted assets and 5 percent for the rest, to use 0 percent for exempted assets, 1 percent for assets with low expected credit risk, 2 percent with moderate risk, etc.). The Commission believes that these alternatives are overly complicated and may create undue compliance and compliance monitoring burden on market participants and regulators without providing material benefits over the proposed approaches. The Commission requests information about costs and benefits of these alternative risk retention parameters, in particular, the costs and benefits of requiring fixed risk retention amount of more than 5 percent. Because there is no current risk retention requirement or voluntary compliance at levels above 5 percent, the Commission currently lacks sufficient data to quantitatively determine the optimal amount of risk retention across each asset class. The Commission seeks, in particular, data or other comment on the economic effects

of the 5 percent requirement or of other levels that the agencies have the discretion to implement. The Commission also requests comment on methodologies and data that could be used to quantitatively analyze the appropriate level of risk retention, both generally and for each asset class.

Alternative sunset provisions include: requiring sponsors to hold retained pieces until maturity of issued ABS; making the sunset period depend on average maturity of the underlying loans; and making sunset gradual, *i.e.*, to introduce gradual reduction in the retained percentage. At this point, the Commission assumes that these alternatives create additional costs, impose undue compliance and compliance monitoring burden on market participants and regulators without adding benefits. The sunset provision could also be implemented with cut off horizons different from the proposed five years for RMBS and two years for other asset classes and with pool balance cut offs different from the proposed 25 percent and 33 percent respectively. The agencies request information about costs and benefits of these alternative risk retention structures, in particular, about the currently proposed numerical parameters of the sunset provision. The Commission also requests comment on methodologies and data that could be used to quantitatively analyze the appropriate sunset horizons, both generally and for each asset class.

#### 7. Exemptions

As discussed above, there are overarching economic impacts of a risk retention requirement. Below the Commission describes the particular costs and benefits relevant to each of the asset classes included within this rule that the agencies exempt from risk retention.

##### a. Federally Insured or Guaranteed Residential, Multifamily, and Health Care Mortgage Loan Assets

The agencies are proposing, without changes from the original proposal, the exemption from the risk retention requirements for any securitization transaction that is collateralized solely by residential, multifamily, or health care facility mortgage loan assets if the assets are insured or guaranteed in whole or in part as to the payment of principal and interest by the United States or an agency of the United States. The agencies are also proposing, without changes from the original proposal, the exemption from the risk retention requirements for any securitization transaction that involves

the issuance of ABS if the ABS are insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States and that are collateralized solely by residential, multifamily, or health care facility mortgage loan assets, or interests in such assets.

Relative to the baseline there is no cost or benefit associated with this exemption because risk retention is not currently mandated. However, by providing this exemption it will incentivize sponsors to use federally insured or guaranteed assets, which will have an impact on competition with other assets that are not federally insured or guaranteed. The agencies believe it is not necessary to require risk retention for these type of assets because investors will be sufficiently protected from loss because of the government guarantee and adding the cost of risk retention would create costs to sponsors where they are not necessary as the incentive alignment problem is already being addressed.

##### b. Securitizations of Assets Issued, Insured or Guaranteed by the United States or Any Agency of the United States

The rules the agencies are proposing today contain full exemptions from risk retention for any securitization transaction if the ABS issued in the transaction were (1) collateralized solely (excluding servicing assets) by obligations issued by the United States or an agency of the United States; (2) collateralized solely (excluding servicing assets) by assets that are fully insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States (other than residential, multifamily, or health care facility mortgage loan securitizations discussed above); or (3) fully guaranteed as to the timely payment of principal and interest by the United States or any agency of the United States.

Relative to the baseline there is no cost or benefit associated with this exemption because risk retention is not currently mandated. However, by providing this exemption it will incentivize sponsors to use federally insured or guaranteed assets, which will have an impact on competition with other assets that are not federally insured or guaranteed. The agencies believe it is not necessary to require risk retention for these type of assets because investors will be sufficiently protected from loss because of the government guarantee and adding the cost of risk retention would create costs to sponsors where they are not necessary as the

incentive alignment problem is already being addressed.

#### c. QRM

As discussed above, the rules the agencies are re-proposing today exempt from required risk retention any securitization comprised of QRMs. Section 15G requires that ABS that are collateralized solely by QRMs be completely exempted from risk retention requirements, and allows the agencies to define the terms and conditions under which a residential mortgage would qualify as a QRM. Section 15G mandates that the definition of a QRM be “no broader than” the definition of a “qualified mortgage” (QM), as the term is defined under Section 129C(b)(2) of the Truth in Lending Act.

Pursuant to the statutory mandate, the agencies have proposed to exempt ABS collateralized by QRMs, and pursuant to the discretion permitted, have proposed defining QRMs broadly as QMs. The Commission believes that this definition of QRM would achieve a number of important benefits. First, since the criteria used to define QMs focus on underwriting standards, safer product features, and affordability, the Commission preliminarily believes that equating QRMs with QMs is likely to promote more prudent lending, protect consumers, and contribute to a sustainable, resilient and liquid mortgage securitization market. Second, the Commission believes that a single mortgage quality standard (as opposed to creating a second mortgage quality standard) would benefit market participants by simplifying the requirements applicable to this market. Third, a broader definition of QRMs avoids the potential effect of squeezing out certain lenders, such as community banks and credit unions, which may not have sufficient resources to hold the capital associated with non-QRM mortgages, thus enhancing competition within this segment of the lending market. The Commission believes that this will increase borrower access to capital and facilitate capital formation in securitization markets. Finally, a broad definition of QRMs may help encourage the re-emergence of private capital in securitization markets. Since Enterprises would have a competitive securitizing advantage because of the proposed recognition of the guarantee of the Enterprises as fulfilling their risk-retention requirement and taxpayer backing, less restrictive QRM criteria would enhance the competitiveness of private securitizations and reduce the need to rely on low down-payment programs offered by Enterprises.

Aligning QRM to QM would build into the provision certain loan product features that data indicates results in a lower risk of default. The Commission acknowledges that QM does not fully address the loan underwriting features that are most likely to result in a lower risk of default. However, the agencies have considered the entire regulatory environment, including regulatory consistency and the possible effects on the housing finance market. In addition, the agencies believe that other steps being considered may provide investors with information that allows them to appropriately assess this risk. The Commission has proposed rules that would require in registered RMBS transactions disclosure of detailed loan-level information at the time of issuance and on an ongoing basis. The proposal also would require that securitizers provide investors with this information in sufficient time prior to the first sale of securities so that they can analyze this information when making their investment decision.<sup>263</sup>

The Commission is aware, however, that defining QRMs broadly to equate with QMs may result in a number of economic costs. First, to the extent that risk retention reduces the risk exposure of ABS investors, a broader definition of QRMs will leave a larger number of ABS investors bearing more risk. Second, securitizers will not be required to retain an economic interest in the credit risk of QRM loans, and thus, the incentives between securitizers and those bearing the credit risk of a securitization will remain misaligned. An analysis of historical performance among loans securitized into private-label RMBS that originated between 1997 and 2009 shows that those meeting the QM standard sustained exceedingly high serious delinquency rates, greater than 30 percent during that period.<sup>264</sup> Third, the QRM exemption is based on the premise that well-underwritten mortgages were not the cause of the financial crisis; however, the criteria for QM loans do not account for all borrower characteristics that may provide additional information about default rates. For instance, borrowers' credit history, their down payment and their loan-to-value ratio have been shown to be significantly associated with lower borrower default rates.<sup>265</sup>

<sup>263</sup> See Asset-Backed Securities, SEC Release No. 33-9117, 75 FR 23328 at 23335, 23355 (May 3, 2010).

<sup>264</sup> See Joshua White and Scott Bauguess, *Qualified Residential Mortgage: Background Data Analysis on Credit Risk Retention*, (August 2013), available at <http://www.sec.gov/divisions/riskfin/whitepapers/qrm-analysis-08-2013.pdf>

<sup>265</sup> *Id.*

Fourth, allowing securitizers to bear less risk in their securitizations avoids moderation of non-observable risk factors that could substantially harm ABS investors during contractionary housing periods. That is, investors would be better protected by a narrower QRM standard. Fifth, commenters argued that not allowing blended pools of QRMs and non-QRMs to qualify for a risk-retention exemption may limit securitizations, if lenders cannot originate enough QRMs. Although broadening the definition of QRMs reduces this concern, since blended pools will still require risk retention, mortgage liquidity may still be reduced.

#### d. Qualified Automobile Loans, Qualified Commercial Real Estate Loans and Qualified Commercial Loans

Similar to RMBS discussed above, the agencies have proposed to exempt securitizations containing certain qualified loans from the risk retention requirement. Specifically, the agencies proposed an exemption for qualified automobile loans, qualified commercial real estate loans and commercial loans. The benefit to exempted qualified loans from risk retention is that sponsors will have more capital available to deploy more efficiently. The economic consequences of exempting qualified loans are analogous to the discussion associated with requiring stricter lending standards than QM in the residential lending market. Also there will be fewer administrative, monitoring and compliance costs to be met due to the lack of risk retention. Lower costs of securitizing loans may enhance competition in the market for qualified auto, commercial real estate and commercial loans by allowing more firms to be profitable by exempting certain type of loans, sponsors have an incentive to misrepresent qualifications of loans, similar to what was observed in the financial crisis. One qualification surrounding whether or not a loan is qualified is that the sponsor is required to purchase any loan that fails to meet the underwriting criteria. The benefit of the previous qualification is that it helps to prevent and disincentivize sponsors from trying to include unqualified loans in the securitization.

#### e. Resecuritizations

The agencies have identified certain resecuritizations where duplicative risk retention requirements would not appear to provide any added benefit. Resecuritizations collateralized only by existing 15G-compliant ABS and financed through the issuance of a single class of securities so that all principal and interest payments

received are evenly distributed to all security holders, are a unique category of resecuritizations. For such transactions, the resecuritization process would neither increase nor reallocate the credit risk of the underlying ABS. Therefore, there would be no potential cost to investors from possible incentive misalignment with the securitizing sponsor. Furthermore, because this type of resecuritization may be used to aggregate 15G-compliant ABS backed by small asset pools, the exemption for this type of resecuritization could improve access to credit at reasonable terms to consumers and businesses by allowing for the creation of an additional investment vehicle for these smaller asset pools. The exemption would allow the creation of ABS that may be backed by more geographically diverse pools than those that can be achieved by the pooling of individual assets as part of the issuance of the underlying 15G-compliant ABS. Again, this will likely improve access to credit on reasonable terms.

Under the proposed rule, sponsors of resecuritizations that do not have the structure described above would not be exempted from risk retention. Resecuritization transactions, which re-tranche the credit risk of the underlying ABS, would be subject to risk retention requirements in addition to the risk retention requirement imposed on the underlying ABS. In such transactions, there is the possibility of incentive misalignment between investors and sponsors just as when structuring the underlying ABS. For such resecuritizations, the proposed rule seeks to ensure that this misalignment is addressed by not granting these resecuritizations with an exemption from risk retention. The proposed rules may have an adverse impact on capital formation and efficiency if they make certain resecuritization transactions costlier or infeasible to conduct.

#### f. Other Exemptions

There are a few exemptions from risk retention included in the current proposal that were not included in the original proposal. They include exemptions for utility legislative securitizations, two options for municipal bond “repackaging” securitizations, and seasoned loans.

With respect to utility legislative securitizations, the agencies believe the implicit state guarantee in place for these securitizations addresses the moral hazard problem discussed above and adding the cost of risk retention would create costs to sponsors where they are not necessary as the incentive

alignment problem is already being addressed.

For municipal bond repackaging securitizations, the agencies believe that the risk retention mechanisms already in place for these securitizations already serve to address the moral hazard problem discussed above and thus have proposed two options that would reflect current market practice.

Seasoned loans have had a sufficient period of time to prove their performance and the agencies believe that providing an exemption for these assets consistent with the sunset in place for risk retention requirements addresses the moral hazard problem discussed above and adding the cost of risk retention would create costs to sponsors where they are not necessary as the incentive alignment problem is already being addressed.

Relative to the baseline there is no cost or benefit associated with these exemptions because risk retention is not currently mandated. However, providing these exemptions would incentivize the creation of utility legislative securitizations, municipal bond “repackaging” securitizations, and securitizations with seasoned loans, which will have an impact on competition with other securitizations.

#### g. Alternatives

Commenters asked for exemptions for specific asset classes such as: rental car securitization, tax lien-backed securities sponsored by a municipal entity, “non-conduit” CMBS transactions, corporate debt repackagings, and legacy loan securitizations. The agencies chose not to provide exemptions for these asset classes because the cost associated with retaining risk provided a benefit for these asset classes by aligning the incentive of the sponsor and the investor. These asset classes had either unfunded risk retention already in practice or had loans created before the new underwriting qualifications were in place. In either case there exists a misalignment between the sponsor and investors. In order to resolve this moral hazard risk retention is required.

#### 8. Hedging, Transfer and Financing Restrictions

Under the proposal, a sponsor and its consolidated affiliates generally would be prohibited from hedging or transferring the risk it is required to retain, except for currency and interest rate hedges and some index hedging. Additionally, the sponsor would be prohibited from financing the retained interest on a non-recourse basis.

The main purpose of the hedging/transfer restrictions is to enforce the

economic intent of the risk retention rule. Without the hedging/transfer restrictions, sponsors could hedge/transfer their (credit) risk exposure to the retained ABS pieces, thereby eliminating the “skin in the game” intent of the rule. Thus, the restriction is intended to prevent evasion of the rule’s intent.

Costs related to the hedging/transfer restrictions include direct administrative costs and compliance monitoring costs. Additionally, according to a few commenters, there is uncertainty about the interpretation of the proposed rules, namely, what constitutes permissible and impermissible hedges. Such uncertainty may induce strategic responses that are designed to evade the without violating the letter of the rule. For example, derivative or cash instrument positions can be used to hedge risk, but it may be difficult to determine whether such a hedge is designed to evade the rule.

#### 9. Foreign Safe Harbor

The proposal includes a safe harbor provision for certain, predominantly foreign, transactions based on the limited nature of the transactions’ connections with the United States and U.S. investors. The safe harbor is intended to exclude from the proposed risk retention requirements transactions in which the effects on U.S. interests are sufficiently remote so as not to significantly impact underwriting standards and risk management practices in the United States or the interests of U.S. investors. The exclusion would create compliance and monitoring cost savings compared to universally applying the risk retention rules to all ABS issues.

The costs of foreign safe harbor exemptions would be small. ABS deals with a share of U.S. assets slightly above the threshold of 25 percent and sold primarily to foreign investors may be restructured by sponsors to move the share below the threshold to avoid the need to satisfy the risk retention requirements. The number of such deals will likely be small<sup>266</sup> and the resulting economic costs will be minimal.

There will be negligible effect of the exclusion on efficiency, competition and capital formation (compared to the universal application of the risk retention rule) because the affected ABS are foreign and not related to U.S. markets. In some instances, allowed by the foreign safe harbor provision, the effect on capital formation in the United

<sup>266</sup> Since 2009, only 0.26 percent of all ABS in AB Alert database had primary location of collateral in the U.S., but were distributed outside of the U.S.

States would be positive. For example, foreign sponsors which acquire less than 25 percent of assets in the pool in the United States and sell the ABS to foreign investors to avoid risk retention requirement would create capital in the United States. The prevalence of such situations would depend on relative strictness of the United States and foreign risk retention rules, tax laws, and other relevant security regulations. (see also footnote 36). The effect of the same scenario on competition may be marginally negative for the United States sponsors involved in similar transactions (securitizing U.S.-based assets for sale to foreign investors) because the U.S. sponsors have to retain risk pieces by the virtue of being organized under the laws of the U.S.

The proposal may have negative effect on foreign sponsors that seek U.S. investors because they may need to satisfy risk retention requirements of two countries (their home country and the United States) and, thus, the rule may reduce competition and investment opportunities for U.S. investors. The proposed rule is designed to provide flexibility for sponsors with respect to forms of eligible risk retention to permit foreign sponsors seeking a material U.S. investor base to retain risk in a format that satisfies both home country and U.S. regulatory requirements, without jeopardizing protection to the U.S. investors in the form of risk retention.

#### 10. Request for Comment

The Commission requests comments on the following questions:

1. Are the descriptions of the current risk retention practices and structures or practices that align the interests of investors and sponsors correct with respect to all ABS asset classes, but, in particular, in the following: ABCP, CLO, RMBS, automobile loan backed ABS, and master trusts with seller's interests?

2. With respect to current risk retention practices: what share of ABS interest is currently retained (less/more than 5 percent)? What type of ABS interest is currently retained (horizontal, vertical, L-shaped, seller's interest)? When was this practice or structure developed (before or after the crisis, before or after the promulgation of Dodd-Frank Act)? Is information about risk retention (size or shape) for specific transactions disclosed to investors? To what extent is this practice or structure in response to regulatory restrictions (e.g., EU risk retention regulations or the FDIC safe harbor)?

3. Is there a difference in historical delinquency rates/performance of securitizations in which the sponsor retained ABS interests and

securitizations in which the sponsor did not retain ABS interests? Is there a difference in the timing of defaults of securitizations in which the sponsor retained ABS interests and securitizations in which the sponsor did not retain ABS interests?

4. What are the estimates of the potential costs of appointing the independent operating advisors for the proposed CMBS B-piece option?

5. To what extent do the sponsor and/or its affiliates receive subordinated performance fees with respect to a securitization transaction? Are the subordinated performance fees received by the sponsor and its affiliates equal to or greater than the economic exposure they would get from the 5 percent risk retention requirements? Because subordinated performance fees only align incentives when the assets are performing above a certain threshold, should there be any additional restrictions on the use of performance fees to satisfy risk retention requirements?

6. To the extent not already provided, what are the estimates of the cost (including opportunity cost) of 5 percent risk retention and how will 5 percent retention affect the interest rates paid by borrowers under securitized loans?

7. What would be the costs of establishing the risk retention level above the statutory 5 percent? What would be the benefits?

8. Are there any additional costs that the agencies should consider with respect to the risk retention?

9. Are the sunset provision appropriate for RMBS (*i.e.*, the latter of (x) 5 years and (y) the reduction of the asset pool to 25% of its original balance, but (z) no longer than 7 years) and all other asset classes (*i.e.*, the latter of (x) 2 years and (y) the reduction of the asset pool balance to 33%)? What data can be used to support these or alternative sunset bounds?

10. To what extent do the requirements and/or restrictions included in each of the risk retention options limit the ability of sponsors to use the option?

11. To what extent are the deals funded by ABCP conduits included in the deal volumes for other asset classes?

12. To the extent that a warehouse line is funded by the issuance of revolving ABS, is that ABS included in the deal volume?

13. It would be helpful to receive additional information about the fees charged by sponsors for setting up securitizations, sponsors interpretation of their opportunity cost of capital, the interaction of regulatory capital with

cost of capital, and historical returns of tranches of different asset classes in particular the residual interest.

14. The Commission requests data about master trusts that would permit it to estimate the amount of risk currently retained.

15. The Commission currently lacks sufficient data to quantitatively assess the potential impact of the proposed minimum 5 percent retention requirement. In connection with the re-proposal, the Commission seeks data or other comment on the economic effects of the proposed minimum 5 percent requirement.

The Commission also requests comment on methodologies and data that could be used to quantitatively analyze the appropriate level of risk retention, both generally and for each asset class.

#### Appendix: The Impact of Required Risk Retention on the Cost of Credit

In this section, we outline a framework for evaluating the impact of required risk retention on the cost of credit, and apply it to a hypothetical securitization of prime mortgages. While the ultimate impact of required risk retention depends in part on the assumptions about how risk retention is funded by the sponsor, we conclude that incremental risk retention by the sponsor is unlikely to have a significant impact on the cost of credit. Our range of reasonable estimates of the cost of risk retention is between zero and 30 basis points. The former estimate is relevant when incremental retention is zero. The latter is relevant when the sponsor is currently retaining nothing, and incremental retention is funded entirely with sponsor equity.

##### I. Conceptual Framework

The analysis below focuses on the impact of risk retention on the cost of credit through the cost of funding. If capital markets are efficient, the cost of funding an ABS interest directly in capital markets should be no different than funding the same ABS interest on the balance sheet of the sponsor. However, when capital markets are not efficient, risk retention can be costly, as the cost of funding credit through securitization is lower than funding on the sponsor's balance sheet. Here, we focus on measuring how much risk retention can increase the cost of credit to borrowers by forcing a sponsor to increase the amount of retention it is funding on its balance sheet.<sup>267</sup>

<sup>267</sup> As this cost is driven by financial market inefficiency, it is worth noting that financial

The analysis starts by identifying the marginal amount and form of retention. In a typical securitization transaction, the sponsor is currently holding some risk retention without being prompted by regulation, typically in a first-loss position. In some circumstances, the proposed rule will increase the overall amount of retention by the sponsor, and it is only this increase that will have an impact on the cost of credit. If the sponsor's risk retention is already adequate to meet the rule, the implication is that the impact of the rule on the cost of credit is zero. In the analysis here, we focus first on the marginal retention required by the sponsor to meet the rule.<sup>268</sup>

(1) Marginal Risk Retention = Required Risk Retention – Current Risk Retention

For the purposes of this example, assume the sponsor currently holds a first loss position equal to 3 percent of the fair value of all ABS interests (Current Risk Retention), and consequently needs to hold eligible interests with fair value of an additional 2 percent (Marginal Risk Retention) in order to meet the 5 percent standard (Required Risk Retention).

We assume that the sponsor has three options to fund this Marginal Risk Retention of 2 percent. In the first option, the sponsor funds entirely with new equity. In the second option, the sponsor funds part of the marginal risk retention with maturity-matched debt secured by the ABS interest and recourse to the sponsor, and the rest with new equity. In the final option, the sponsor funds part of the marginal risk retention with short-term bi-lateral repo secured by the ABS interest and recourse to the sponsor, and the rest with new equity.

Regardless of the funding strategy, the framework outlined below is focused on calculating the sponsor's return on marginal equity. This calculation has three components: The Amount of Incremental Equity by the sponsor, the Gross Yield on the Retained ABS Interest, and the Cost of Debt Funding. We review each of these in turn. The amount of incremental equity is simply the amount of incremental funding in

innovation which reduces or eliminates this inefficiency over time will subsequently reduce or eliminate these costs.

<sup>268</sup> It is possible that restrictions proposed above on the timing of cash flow to an eligible horizontal residual interest (EHRI) will also have an impact on the cost of credit. In particular, an increase in the duration of first-loss cash flows may prompt the sponsor to increase the required yield on the EHRI. As we have found reasonable changes in the yield to have insignificant impact on the analysis here, it is ignored for simplicity.

the form of sponsor equity, and it varies across sponsor funding strategy.

(2) Amount of Incremental Equity = Percent of Equity in Incremental Funding x Marginal Risk Retention (1)

Assuming the marginal risk retention requirement of 2 percent from the example above, when the sponsor funds marginal risk retention only with equity, the Percent Equity in Incremental Funding is 100 percent, and the Amount of Incremental Equity is 2 percent ( $= 1 \times 0.02$ ). However, if the sponsor funds with 80 percent term debt, the Percent of Equity in Incremental Funding is 20 percent, and the Amount of Incremental Equity is 0.4 percent ( $= 0.20 \times 0.02$ ). Finally, when the sponsor funds marginal risk retention with bi-lateral repo of 90 percent, the Percent of Equity in Incremental Funding would be 10 percent, and the Amount of Incremental Equity is 0.2 percent ( $= 0.10 \times 0.02$ ).

The Gross Yield at Issue on the Marginal Retained ABS interests by the sponsor is an important input to the calculation below, as it measures the sponsor's return from holding risk retention. As the gross yield increases, all else equal, the cost of risk retention will decrease, as the sponsor is being compensated more for its position.

(3) Gross Yield = Yield at Issue on Marginal Retained ABS Interest(s)

In the motivating example here, we assume the gross yield on marginal ABS interests retained is 4 percent.

In order to calculate the return on marginal equity, it is necessary to measure the difference between Gross Yield and the Cost of Debt Funding, where the latter is simply the product of the cost of incremental debt funding times the amount of debt in the capital structure.

(4) Cost of Debt Funding = Percent of Debt in Incremental Funding x Cost of Incremental Debt

When the sponsor only uses equity to fund incremental retention, the amount of incremental debt is 0 percent and Cost of Debt Funding is zero. When the sponsor uses term debt in 80 percent of the capital structure at a cost of 5 percent, the Cost of Debt Funding is 4 percent ( $= 0.8 \times 0.05$ ). Finally, when the sponsor uses bi-lateral repo in 90 percent of the capital structure at a cost of 4 percent, the Cost of Debt Funding is 3.6 percent ( $= 0.9 \times 0.04$ ).

The next step in calculating the marginal return on equity is measurement of the Net Yield on marginal retention, which is equal to the difference between the gross yield and the cost of debt funding.

(5) Net Yield = Gross Yield (3) – Cost of Debt Funding (4)

In our examples from above, the Net Yield of the all equity funding strategy is 4 percent ( $= 0.04 - 0$ ), of the term debt funding strategy is 0 percent ( $= 0.04 - 0.04$ ), and of the bi-lateral repo funding strategy is 0.4 percent ( $= 0.04 - 0.036$ ) percent. Finally, the Return on Marginal Equity is the ratio of the Net Yield to the Amount of Incremental Equity. It is the actual return to marginal sponsor equity, taking the current cost of credit as given.

(6) Return on Marginal Equity = Net Yield (5) / Percent of Equity in Incremental Funding

In our examples from above, the Return on Marginal Equity of the all equity funding strategy is 4 percent ( $= 0.04 / 1$ ), of the term debt funding strategy is 0 percent ( $= 0 / 0.2$ ), and of the bi-lateral repo funding strategy is 4 percent ( $= 0.004 / 0.1$ ).

These Returns on Marginal Equity are likely to be too low to incent the sponsor to go forward with the transaction. In order to remediate this problem, we measure the ROE shortfall as the difference, if positive, between the sponsor's target return on marginal equity and the actual return on marginal equity. This number represents how much the sponsor's ROE on marginal equity needs to increase to meet the target return.

(7) ROE Shortfall = max (0, Target Return on Equity - Return on Marginal Equity (6))

While we will let the target Return on Marginal Equity vary with the funding strategy and risk of the ABS interest retained in the detailed example below, for simplicity assume now that the Target Return on Equity is 10 percent. Following our example, this leads to an ROE shortfall of 6 percent ( $= 0.10 - 0.04$ ) for the all equity strategy, of 10 percent ( $= 0.10 - 0.0$ ) for the term debt funding strategy, and of 6 percent ( $= 0.10 - 0.04$ ) for the bi-lateral repo funding strategy.

In order to eliminate the shortfall, it is necessary to increase the Return on Marginal Equity, which is done by generating more cash flow for the sponsor. As all cash flow has been exhausted through payments to ABS interests, this can only be done by increasing the yield on the underlying assets, which is the measured increase in the cost of credit. Note that the incremental cash flow from the higher mortgage coupon only needs to flow to the sponsor.<sup>269</sup>

<sup>269</sup> In particular, since we have valued all of the other ABS interests at market prices, and the rule

While it is unclear how a sponsor might ultimately structure the transaction to capture this incremental cash flow, we assume for illustrative purposes here that the sponsor creates a senior IO strip in the amount of the incremental yield on the assets, and holds that IO strip along with incremental retention.<sup>270</sup> As the sponsor receives 100 percent of the cash flow from the incremental cost of credit, small changes in the cost of credit can have a large impact on the return on marginal equity.<sup>271</sup>

In our example when the sponsor funds incremental risk retention entirely with equity, an increase in the yield on assets by 12 basis points, when divided by the amount of incremental equity of 2 percent, results in an additional return to marginal equity of 6 percent ( $=0.12/0.02$ ). It follows that it would only take a 12 basis point increase in the cost of credit to compensate the sponsor for the funding cost of incremental risk retention entirely with equity when

using a Target Return on Incremental Equity of 10 percent.

More generally, the potential impact of risk retention on the cost of credit is equal to the product of the ROE shortfall and the amount of incremental equity.

(8) Impact on Cost of Credit = ROE shortfall (7)  $\times$  Amount of Incremental Equity (2) Substituting earlier equations into (8) results in the simple following approximation to the impact of risk retention on the cost of credit:

(9) Impact on the Cost of Credit = Max {0, Target Return on Marginal Equity - [Yield on Marginal Retained Interest - (Cost of Incremental Debt  $\times$  (1 - Amount of Incremental Equity))] / Amount of Incremental Equity}  $\times$  Amount of Incremental Risk Retention  $\times$  Amount of Incremental Equity

The equation above demonstrates that the impact of the proposed rule on the cost of credit is increasing in the following variables: (i) Target return on marginal equity, (ii) cost of incremental debt, (iii) amount of incremental risk retention, and (iv) yield on marginal

retained interest. The impact of the amount of incremental equity is ambiguous, as it depends on the cost of incremental debt.

## II. Application

In order to illustrate the framework, we will focus on the hypothetical securitization of prime mortgage loans illustrated below. The first column documents class name, the second column documents tranche NRSRO rating, the third column documents tranche type, the fourth column face amount, the fifth column documents tranche coupon, and the sixth column is the ratio of tranche face amount (4) to total face amount (the sum of face amounts for all non-IO tranches). Using cash flow assumptions consistent with prime mortgage loans as well as the yield assumption from (9), we compute the price in column (7).<sup>272</sup> The value (8) is simply equal to the price (7) multiplied by the balance (6) divided by 100.

**Figure A1: Capital structure of hypothetical securitization of prime mortgage loans**

Tranche	Ratings	Tranche Type	Amount	Coupon	Balance	Price	Value	Yield
A1	AAA	SEN_FIX_CAP	130,000,000	2.50%	30.6%	99.52	30.44%	2.59%
A2	AAA	SEN_FIX_CAP	267,343,000	3.00%	62.9%	101.67	63.96%	2.57%
AIO1	AAA	SEN_FLT_IO	130,000,000	0.50%	30.6%	2.13	0.65%	1.61%
AIO2	AAA	SEN_FLT_IO	397,343,000	0.54%	93.5%	2.18	2.04%	3.11%
B1	AA	JUN_WAC	7,649,000	3.54%	1.8%	100.85	1.82%	3.41%
B2	A	JUN_WAC	7,012,000	3.54%	1.7%	97.27	1.60%	3.92%
B3	BBB	JUN_WAC	6,374,000	3.54%	1.5%	90.55	1.36%	4.95%
B4	BB	JUN_WAC	2,125,000	3.54%	0.5%	69.01	0.35%	8.92%
B5	NR	JUN_WAC	4,463,577	3.54%	1.1%	28.00	0.29%	18.98%
<b>Total Fair Value</b>							<b>102.51%</b>	

### The Amount and Form of Risk Retention

There are three ways for the sponsor of this mortgage transaction to comply

with the proposed rule which we will evaluate here: an eligible horizontal retained interest, a vertical interest, or

an L-shaped interest. We review each of these in turn.

does not affect investors in those interests, it is safe to assume those tranches can continue to be sold at the same price. It is possible that risk retention could reduce the yield demanded by investors on those interests, but for conservatism we ignore that impact here.

<sup>270</sup> It is possible that the sponsor would structure this cash flow to be an eligible form of retention,

and reduce the amount of incremental retention, but for conservatism we ignore that impact here.

<sup>271</sup> The impact of the higher coupon on the return on marginal equity is driven by two factors. First, a one basis point increase in the mortgage coupon only has to be distributed to the sponsor's incremental ABS interest, which in this example is only 2 percent. Second, when the sponsor uses leverage through debt, the amount of marginal

equity is a fraction of the incremental ABS interest. These two levels of leverage permit small changes in the mortgage coupon to have a relatively large impact on the return on marginal equity.

<sup>272</sup> The analysis assumes 15 percent CPR (constant prepayment rate), 0 percent CDR (constant default rate), 30 percent loss severity, 24-month recovery lag, and employs the forward interest rate curve as of 22 May 2013.

**Figure A2: Illustrating Sponsor Compliance with the Proposed Rule**

	Retention Amounts					
	Horizontal		L-Shaped		Vertical	
	% Par	% Value	% Par	% Value	% Par	% Value
<b>A1</b>	0.00%	0.00%	4.40%	1.34%	5.00%	1.52%
<b>A2</b>	0.00%	0.00%	4.40%	2.82%	5.00%	3.20%
<b>A101</b>	0.00%	0.00%	4.40%	0.03%	5.00%	0.03%
<b>A102</b>	0.00%	0.00%	4.40%	0.09%	5.00%	0.10%
<b>B1</b>	83.92%	1.52%	4.40%	0.08%	5.00%	0.09%
<b>B2</b>	100.00%	1.60%	4.40%	0.07%	5.00%	0.08%
<b>B3</b>	100.00%	1.36%	4.40%	0.06%	5.00%	0.07%
<b>B4</b>	100.00%	0.35%	100.00%	0.35%	5.00%	0.02%
<b>B5</b>	100.00%	0.29%	100.00%	0.29%	5.00%	0.01%
Total		5.13%		5.13%		5.13%
(3) Gross Yield		5.24%		4.01%		2.71%

Under the horizontal risk retention option, the sponsor must hold ABS interests from the bottom of the capital structure up until the value of those interests is no less than 5 percent of the fair value of ABS interests. As the value of all ABS interests is \$102.5 from Figure A1, the value of the horizontal form must be 5.13 percent ( $=\$102.5 \times 5\%$ ). The table above illustrates that in order for the sponsor to comply with the rule, the sponsor must hold 83.92 percent of the B1 tranche, as well as 100 percent of all junior tranches, in order to meet required retention with horizontal. The value-weighted yield on this interest is 5.24 percent.

Under the L-shaped risk retention option, the sponsor can hold any combination of horizontal and vertical interests as long as the aggregate fair value is 5.13 percent. We focus here on the sponsor holding the non-investment

grade part of the capital structure as horizontal and the rest vertical. The middle columns illustrate that the bottom two tranches (B4 and B5), together represent about 0.64 percent of fair value, implying that the sponsor needs to hold vertical interests with fair value of 4.49 percent. The table illustrates that holding 4.4 percent of each of the remaining ABS interests accomplishes this requirement, resulting in a value-weighted yield of 4.01 percent.

Finally, under the vertical risk retention option, the sponsor must hold 5 percent of each ABS interest, which mechanically ensures that the fair value of those interests is equal to 5.13 percent, and has a yield of 2.71 percent.

#### *The Cost of All Equity Funding*

In this section we take the conservative approach that eligible risk

retention is funded entirely with equity. As finance theory suggests that the required return on sponsor equity should be determined largely by the risk of asset funded by equity, we assume that equity has a required risk-adjusted rate of return which is increasing in the risk of the marginal retained ABS interest. In particular, when equity is funding the safest form of risk retention—the vertical form—we assume the required yield is only 7 percent. However, when equity is funding the L-shaped form, which is more risky than the vertical form but not as risky as horizontal form, we assume the required yield increases to 9 percent. Finally, when equity is funding the horizontal form, the most risky of all eligible forms, we assume the required yield is 11 percent.

**Figure A3**

	Full Equity Funding					
	Horizontal		L-Shaped		Vertical	
	Cost	Amount	Cost	Amount	Cost	Amount
Repo Debt in incremental funding	4.25%	0.00%	4.25%	0.00%	4.25%	0.00%
Term Debt in incremental funding	6.25%	0.00%	6.25%	0.00%	6.25%	0.00%
Equity in incremental funding	11.00%	100.00%	9.00%	100.00%	7.00%	100.00%
(3) Gross Yield	5.24%		4.01%		2.71%	
(4) Cost of Debt	0.00%		0.00%		0.00%	
(5) Net Yield	5.24%		4.01%		2.71%	
(6) Return on marginal equity	5.24%		4.01%		2.71%	
(7) ROE Shortfall	5.76%		4.99%		4.29%	
(2) Amount of incremental equity	5.00%		5.00%		5.00%	
(8) Impact on cost of credit	0.29%		0.25%		0.21%	

In the “ROE from Retained” row, the table reports the actual return on equity from the retained position, which in every circumstance is below the target

return on equity. This difference, measured in the next row as “ROE shortfall,” measures the additional yield which must be generated in order

compensate equity for its required return. For example, when horizontal is funded by full equity, the ROE is 5.24

percent, which is 5.76 percent below the target return of 11 percent.

For conservatism, we assume that the sponsor was not retaining anything without the rule, so the “Marginal Equity” is 5 percent. The last row computes the coupon impact, which is simply equal to the product of Marginal Equity and the ROE shortfall, as all additional cash flow from a higher mortgage coupon can be directed to equity. Overall, the table illustrates that in a conservative funding structure, where the sponsor had no retention before the rule, the impact of the

proposed rule on the mortgage coupon varies between 21 and 29 basis points.

#### *The Cost of Risk Retention With Term Debt Funding*

In the example below, we focus on sponsor funding of incremental risk retention using a capital structure which varies with the risk of the underlying incremental ABS interest: 20 percent equity when incremental retention is horizontal, 10 percent equity when incremental retention is L-shaped interest, and 5 percent equity when incremental retention is vertical. The

cost of term debt is assumed to be 30-day LIBOR plus 6 percent, using the average for a BBB-rated sponsor at a maturity of 7–10 years. Given the presence of leverage in the capital structure, we assume the cost of equity is 2 percentage points higher to fund each type of ABS interest than when funded entirely with equity. Using the conceptual framework outlined above, the measured impact of risk retention on the cost of credit, illustrated in the last line, varies between 12 and 18 basis points.<sup>273</sup>

**Figure A4**

	Term Debt					
	Horizontal		L-Shaped		Vertical	
	Cost	Amount	Cost	Amount	Cost	Amount
Repo Debt in incremental funding	4.25%	0.00%	4.25%	0.00%	4.25%	0.00%
Term Debt in incremental funding	6.25%	80.00%	6.25%	90.00%	6.25%	95.00%
Equity in incremental funding	13.00%	20.00%	11.00%	10.00%	9.00%	5.00%
(3) Gross Yield	5.24%		4.01%		2.71%	
(4) Cost of Debt	5.00%		5.63%		5.94%	
(5) Net Yield	0.24%		-1.62%		-3.22%	
(6) Return on marginal equity	1.22%		-16.19%		-64.47%	
(7) ROE Shortfall	11.78%		27.19%		73.47%	
(2) Amount of incremental equity	1.00%		0.50%		0.25%	
Coupon Impact	0.12%		0.14%		0.18%	

#### *The Cost of Risk Retention With Bi-Lateral Repo Funding*

In the final approach, we permit the sponsor to follow a more aggressive strategy where funding eligible risk retention is funded in part with bi-lateral repo. In particular, we assume that only the investment-grade portion of the retained interest is funded by

repo, with a haircut of 10 percent and cost of 4.25 percent, and the rest is funded with equity. The cost of repo funding includes a cost of 30-day LIBOR plus 2 percent to the repo counterparty combined with a cost of 2 percent for a fixed-for-floating rate interest rate swap, using a maturity of seven years. As repo involves maturity transformation and creates unique risks to the sponsor

beyond those created just by leverage, we further increase the cost of equity funding by another 2 percentage points above and beyond the equity yield used in the term leverage example above. Results suggest that the impact of the proposed rule on the cost of credit, when a sponsor funds the marginal retained interest with bi-lateral repo, is between 6 and 12 basis points.

<sup>273</sup> For simplicity, we do not vary the cost of debt across the risk of the asset portfolio, as this has a second-order impact on the result.

**Figure A5**

	Repo Funding					
	Horizontal		L-Shaped		Vertical	
	Cost	Amount	Cost	Amount	Cost	Amount
Repo Debt in incremental funding	4.25%	78.78%	4.25%	76.70%	4.25%	87.08%
Term Debt in incremental funding	6.25%	0.00%	6.25%	0.00%	6.25%	0.00%
Equity in incremental funding	15.00%	21.22%	13.00%	23.30%	11.00%	12.92%
(3) Gross Yield	5.24%		4.01%		2.71%	
(4) Cost of Debt	3.35%		3.26%		3.70%	
(5) Net Yield	1.90%		0.75%		-0.99%	
(6) Return on marginal equity	8.93%		3.20%		-7.64%	
(7) ROE Shortfall	6.07%		9.80%		18.64%	
(2) Amount of incremental equity	1.06%		1.17%		0.65%	
Coupon Impact	0.06%		0.11%		0.12%	

#### *D. OCC Unfunded Mandates Reform Act of 1995 Determination*

Section 202 of the Unfunded Mandates Reform Act of 1995, Public Law 104-4 (UMRA) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in an expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of \$100 million, adjusted for inflation, (\$150 million in 2013) or more in any one year. If a budgetary impact statement is required, section 205 of the UMRA also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule.

Based on current and historical supervisory data on national bank and Federal savings association securitization activity, the OCC estimates that as of December 31, 2012, there were 56 national banks and Federal savings associations that engaged in any securitization activity during that year. These entities may be affected by the proposed rule. Pursuant to the proposed rule, national banks and Federal savings associations would be required to retain approximately \$3.0 billion of credit risk, after taking into consideration the proposed exemptions for QRMs and other qualified assets. This amount reflects the marginal increase in risk retention required to be held based on the proposed rule, that is, the total risk retention required by the rule less the amount of ABS interests already held by securitizers that would meet the definitions for eligible risk retention.

The cost of retaining these interests has two components. The first is the loss of origination and servicing fees on the reduced amount of origination activity necessitated by the need to hold the \$3.0 billion retention amount on the

bank's balance sheet. Typical origination fees are 1 percent and typical servicing fees are another half of a percentage point. To capture any additional lost fees, the OCC conservatively estimated that the total cost of lost fees to be 2 percent of the retained amount, or approximately \$60 million. The second component of the retention cost is the opportunity cost of earning the return on these retained assets versus the return that the bank would earn if these funds were put to other use. Because of the variety of assets and returns on the securitized assets, the OCC assumes that this interest opportunity cost nets to zero.

In addition to the cost of retaining the assets under the proposed rule, the overall cost of the proposed rule includes the administrative costs associated with implementing the rule and providing the required disclosures. The OCC estimates that the implementation and disclosure will require approximately 480 hours per institution, or at \$92 per hour, approximately \$44,000 per institution. The OCC estimates that the rule will apply to as many as 56 national banks and Federal savings associations. Thus, the estimated total administrative cost of the proposed rule is approximately \$2.5 million, and the estimated total cost of the proposed rule applied to ABS is \$62.5 million.

The OCC has determined that its portion of the final rules will not result in expenditures by State, local, and tribal governments, or by the private sector, of \$150.0 million or more. Accordingly, the OCC has not prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered.

#### *E. Commission: Small Business Regulatory Enforcement Fairness Act*

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"<sup>274</sup> the Commission solicits data to determine whether the proposal constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

- An annual effect on the economy of \$100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries;
- or
- Significant adverse effects on competition, investment or innovation.

We request comment on the potential impact of the proposal on the U.S. economy on an annual basis, any potential increase in costs or prices for consumers or individual industries, and any potential effect on competition, investment or innovation. Commenters are requested to provide empirical data and other factual support for their views if possible.

#### *F. FHFA: Considerations of Differences Between the Federal Home Loan Banks and the Enterprises*

Section 1313 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 requires the Director of FHFA, when promulgating regulations relating to the Federal Home Loan Banks (Banks), to consider the following differences between the Banks and the Enterprises (Fannie Mae and Freddie Mac): cooperative ownership structure; mission of providing liquidity to members; affordable housing and community development mission; capital structure; and joint and several

<sup>274</sup>Public Law 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

liability.<sup>275</sup> The Director also may consider any other differences that are deemed appropriate. In preparing the portions of this proposed rule over which FHFA has joint rulemaking authority, the Director considered the differences between the Banks and the Enterprises as they relate to the above factors. FHFA requests comments from the public about whether differences related to these factors should result in any revisions to the proposal.

### Text of the Proposed Common Rules (All Agencies)

The text of the proposed common rules appears below:

## PART \_\_\_\_—CREDIT RISK RETENTION

### Subpart A—Authority, Purpose, Scope and Definitions

- Sec.  
\_\_\_\_.1 [Reserved]  
\_\_\_\_.2 Definitions.

### Subpart B—Credit Risk Retention

- \_\_\_\_.3 Base risk retention requirement.  
\_\_\_\_.4 Standard risk retention.  
\_\_\_\_.5 Revolving master trusts.  
\_\_\_\_.6 Eligible ABCP conduits.  
\_\_\_\_.7 Commercial mortgage-backed securities.  
\_\_\_\_.8 Federal National Mortgage Association and Federal Home Loan Mortgage Corporation ABS.  
\_\_\_\_.9 Open market CLOs.  
\_\_\_\_.10 Qualified tender option bonds.

### Subpart C—Transfer of Risk Retention

- \_\_\_\_.11 Allocation of risk retention to an originator.  
\_\_\_\_.12 Hedging, transfer and financing prohibitions.

### Subpart D—Exceptions and Exemptions

- \_\_\_\_.13 Exemption for qualified residential mortgages.  
\_\_\_\_.14 Definitions applicable to qualifying commercial loans, commercial real estate loans, and automobile loans.  
\_\_\_\_.15 Exceptions for qualifying commercial loans, commercial real estate loans, and automobile loans.  
\_\_\_\_.16 Underwriting standards for qualifying commercial loans.  
\_\_\_\_.17 Underwriting standards for qualifying CRE loans.  
\_\_\_\_.18 Underwriting standards for qualifying automobile loans.  
\_\_\_\_.19 General exemptions.  
\_\_\_\_.20 Safe harbor for certain foreign-related transactions.  
\_\_\_\_.21 Additional exemptions.

### Subpart A—Authority, Purpose, Scope and Definitions

#### § \_\_\_\_ .1 [Reserved]

#### § \_\_\_\_ .2 Definitions.

For purposes of this part, the following definitions apply:

*ABS interest* means:

(1) Any type of interest or obligation issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest or residual interest, payments on which are primarily dependent on the cash flows of the collateral owned or held by the issuing entity; and

(2) 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; and

(3) Does not include the right to receive payments for services provided by the holder of such right, including servicing, trustee services and custodial services.

*An affiliate of, or a person affiliated with, a specified person* means a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

*Asset* means a self-liquidating financial asset (including but not limited to a loan, lease, mortgage, or receivable).

*Asset-backed security* has the same meaning as in section 3(a)(79) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(79)).

*Appropriate Federal banking agency* has the same meaning as in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813).

*Collateral* with respect to any issuance of ABS interests means the assets or other property that provide the cash flow (including cash flow from the foreclosure or sale of the assets or property) for the ABS interests irrespective of the legal structure of issuance, including security interests in assets or other property of the issuing entity, fractional undivided property interests in the assets or other property of the issuing entity, or any other property interest in such assets or other property.

Assets or other property *collateralize* an issuance of ABS interests if the assets or property serve as collateral for such issuance.

*Commercial real estate loan* has the same meaning as in § \_\_\_\_ .14.

*Commission* means the Securities and Exchange Commission.

*Control* including the terms “controlling,” “controlled by” and “under common control with”:

(1) Means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

(2) Without limiting the foregoing, a person shall be considered to control another person if the first person:

(i) Owns, controls or holds with power to vote 25 percent or more of any class of voting securities of the other person; or

(ii) Controls in any manner the election of a majority of the directors, trustees or persons performing similar functions of the other person.

*Credit risk* means:

(1) The risk of loss that could result from the failure of the borrower in the case of a securitized asset, or the issuing entity in the case of an ABS interest in the issuing entity, to make required payments of principal or interest on the asset or ABS interest on a timely basis;

(2) The risk of loss that could result from bankruptcy, insolvency, or a similar proceeding with respect to the borrower or issuing entity, as appropriate; or

(3) The effect that significant changes in the underlying credit quality of the asset or ABS interest may have on the market value of the asset or ABS interest.

*Creditor* has the same meaning as in 15 U.S.C. 1602(g).

*Depositor* means:

(1) The person that receives or purchases and transfers or sells the securitized assets to the issuing entity;

(2) 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

(3) 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.

*Eligible horizontal residual interest* means, with respect to any securitization transaction, an ABS interest in the issuing entity:

(1) That is an interest in a single class or multiple classes in the issuing entity, provided that each interest meets, individually or in the aggregate, all of the requirements of this definition;

(2) With respect to which, on any payment date on which the issuing

<sup>275</sup> See 12 U.S.C. 4513.

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 (until the amount of such ABS interest is reduced to zero); and

(3) That has the most subordinated claim to payments of both principal and interest by the issuing entity.

*Eligible vertical interest* means, with respect to any securitization transaction, a single vertical security or 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.

*Federal banking agencies* means the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation.

*GAAP* means generally accepted accounting principles as used in the United States.

*Issuing entity* means, with respect to a securitization transaction, the trust or other entity:

(1) That owns or holds the pool of assets to be securitized; and

(2) In whose name the asset-backed securities are issued.

*Majority-owned affiliate* of a sponsor means an entity that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, the sponsor. For purposes of this definition, 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.

*Originator* means a person who:

(1) Through an extension of credit or otherwise, creates an asset that collateralizes an asset-backed security; and

(2) Sells the asset directly or indirectly to a securitizer or issuing entity.

*Residential mortgage* means a transaction that is a covered transaction as defined in section 1026.43(b) of Regulation Z (12 CFR 1026.43(b)(1)) and any transaction that is exempt from the definition of "covered transaction" under section 1026.43(a) of Regulation Z (12 CFR 1026.43(a)).

*Retaining sponsor* means, with respect to a securitization transaction, the sponsor that has retained or caused to be retained an economic interest in

the credit risk of the securitized assets pursuant to subpart B of this part.

*Securitization transaction* means a transaction involving the offer and sale of asset-backed securities by an issuing entity.

*Securitized asset* means an asset that:

(1) Is transferred, sold, or conveyed to an issuing entity; and

(2) Collateralizes the ABS interests issued by the issuing entity.

*Securitizer* with respect to a securitization transaction shall mean either:

(1) The depositor of the asset-backed securities (if the depositor is not the sponsor); or

(2) The sponsor of the asset-backed securities.

*Servicer* means any person responsible for the management or collection of the securitized assets or making allocations or distributions to holders of the ABS interests, but does not include a trustee for the issuing entity or the asset-backed securities that makes allocations or distributions to holders of the ABS interests if the trustee receives such allocations or distributions from a servicer and the trustee does not otherwise perform the functions of a servicer.

*Servicing assets* means 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.

*Single vertical security* means, with respect to any securitization transaction, 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.

*Sponsor* means 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.

*State* has the same meaning as in Section 3(a)(16) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(16)).

*United States* means the United States of America, its territories and possessions, any State of the United States, and the District of Columbia.

*Wholly-owned affiliate* means an entity (other than the issuing entity)

that, directly or indirectly, wholly controls, is wholly controlled by, or is wholly under common control with, a sponsor. For purposes of this definition, "wholly controls" means ownership of 100 percent of the equity of an entity.

## Subpart B—Credit Risk Retention

### § \_\_\_\_ .3 Base risk retention requirement.

(a) *Base risk retention requirement.* Except as otherwise provided in this part, the sponsor of a securitization transaction (or majority-owned affiliate of the sponsor) shall retain an economic interest in the credit risk of the securitized assets in accordance with any one of §§ \_\_\_\_ .4 through \_\_\_\_ .10.

(b) *Multiple sponsors.* If there is more than one sponsor of a securitization transaction, it shall be the responsibility of each sponsor to ensure that at least one of the sponsors of the securitization transaction (or at least one of their majority-owned affiliates) retains an economic interest in the credit risk of the securitized assets in accordance with any one of §§ \_\_\_\_ .4 through \_\_\_\_ .10.

### § \_\_\_\_ .4 Standard risk retention.

(a) *Definitions.* For the purposes of this section, the following definitions apply:

*Closing Date Projected Cash Flow Rate* for any payment date shall mean the percentage obtained by dividing:

(1) 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 pursuant to this section, 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

(2) 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). In calculating the fair value of cash flows and the amount of cash flow so projected to be paid, the issuing entity shall use the same assumptions and discount rates as were used in determining the fair value of the eligible horizontal residual interest (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).

*Closing Date Projected Principal Repayment Rate* for any payment date shall mean the percentage obtained by dividing:

(1) 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

(2) The aggregate principal amount of all ABS interests issued in the transaction. In calculating the projected principal repayments, the issuing entity shall use the same assumptions 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).

(b) *General requirement.* (1) Except as provided in §§ \_\_\_\_\_.5 through \_\_\_\_\_.10, the sponsor of a securitization transaction must retain an eligible vertical interest or eligible horizontal residual interest, or any combination thereof, in accordance with the requirements of this section. The fair value of the amount retained by the sponsor under this section must equal at least 5 percent of the fair value of all ABS interests in the issuing entity issued as part of the securitization transaction, determined in accordance with GAAP. The fair value of the ABS interests in the issuing entity (including any interests required to be retained in accordance with this part) must be determined as of the day on which the price of the ABS interests to be sold to third parties is determined.

(2) A sponsor retaining any eligible horizontal residual interest (or funding a horizontal cash reserve account) pursuant to this section must prior to the issuance of the eligible horizontal residual interest (or funding of a horizontal cash reserve account), or at the time of any subsequent issuance of ABS interests, as applicable:

(i) Calculate the Closing Date Projected Cash Flow Rate and Closing Date Projected Principal Repayment Rate for each payment date;

(ii) Certify to investors that it has performed the calculations required by paragraph (b)(2)(i) of this section and 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; and

(iii) Maintain record of the calculations and certification required under this paragraph (b)(2) in

accordance with paragraph (e) of this section.

(c) *Option to hold base amount in horizontal cash reserve account.* In lieu of retaining all or any part of an eligible horizontal residual interest under paragraph (b) of this section, the sponsor may, at closing of the securitization transaction, cause to be established and funded, in cash, a horizontal cash reserve account in the amount equal to the fair value of such eligible horizontal residual interest or part thereof, provided that the account meets all of the following conditions:

(1) The account is held by the trustee (or person performing similar functions) in the name and for the benefit of the issuing entity;

(2) Amounts in the account are invested only in:

(i) (A) United States Treasury securities with maturities of one year or less;

(B) 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

(ii) With respect to securitization transactions in which the ABS interests or the securitized assets are denominated in a currency other than U.S. dollars:

(A) Sovereign bonds denominated in such other currency with maturities of one year or less; or

(B) Fully insured deposit accounts denominated, in such other foreign currency and held in 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

(3) Until all ABS interests in the issuing entity are paid in full, or the issuing entity is dissolved:

(i) Amounts in the account shall 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;

(ii) No other amounts may be withdrawn or distributed from the account unless the sponsor has complied with paragraphs (b)(2)(i) and (ii) of this section and the amounts released to the sponsor or other holder of the horizontal cash reserve account do not exceed, on any release date, the Closing Date Principal Repayment Rate as of that release date; and

(iii) Interest on investments made in accordance with paragraph (c)(2) of this section may be released once received by the account.

(d) *Disclosures.* A sponsor relying on this section shall provide, or cause to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities in the securitization transaction the disclosures in written form set forth in this paragraph (d) under the caption "Credit Risk Retention":

(1) *Horizontal interest.* With respect to any eligible horizontal residual interest held under paragraph (a) of this section, a sponsor must disclose:

(i) The fair value (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)) of the eligible horizontal residual interest the sponsor will retain (or did retain) at the closing of the securitization transaction, and the fair value (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)) of the eligible horizontal residual interest that the sponsor is required to retain under this section;

(ii) A description of the material terms of the eligible horizontal residual interest to be retained by the sponsor;

(iii) A description of the methodology used to calculate the fair value of all classes of ABS interests, including any portion of the eligible horizontal residual interest retained by the sponsor;

(iv) 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 but not limited to quantitative information about each of the following, as applicable:

- (A) Discount rates;
- (B) Loss given default (recovery);
- (C) Prepayment rates;
- (D) Defaults;

(E) Lag time between default and recovery; and

(F) The basis of forward interest rates used.

(v) The reference data set or other historical information used to develop the key inputs and assumptions referenced in paragraph (d)(1)(iv) of this section, including loss given default and actual defaults.

(vi) As of a disclosed date which is no more than sixty days prior to the closing

date of the securitization transaction, 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 pursuant to this section, 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.

(vii) If the sponsor retains risk through the funding of a horizontal cash reserve account:

(A) The amount to be placed (or that is placed) by the sponsor in the horizontal cash reserve account at closing, and the fair value (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)) of the eligible horizontal residual interest that the sponsor is required to fund through the cash account under this section; and

(B) A description of the material terms of the horizontal cash reserve account; and

(C) The disclosures required in paragraphs (d)(1)(iii) through (vi) of this section.

(2) *Vertical interest.* With respect to any eligible vertical interest retained under paragraph (a) of this section:

(i) 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 in the issuing entity issued as part of the securitization transaction;

(ii) With respect to an eligible vertical interest retained as a single vertical security:

(A) The fair value amount of the single vertical security that the sponsor will retain (or did retain) at the closing of the securitization transaction and the fair value amount of the single vertical security that the sponsor is required to retain under this section; and

(B) 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 under this section if the sponsor held the eligible vertical interest as a separate proportional interest in each class of ABS interest in the issuing entity; and

(iii) With respect to an eligible vertical interest retained as a separate proportional interest in each class of ABS interests in the issuing entity, 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 under this section; and

(iv) The information required under paragraphs (d)(1)(iii), (iv) and (v) of this section with respect to the measurement of the fair value of the ABS interests in the issuing entity, to the extent the sponsor is not already required to disclose the information pursuant to paragraph (d)(1) of this section.

(e) *Record maintenance.* A sponsor must retain the certifications and disclosures required in paragraphs (b) and (d) of this section in written form in its records and must provide the disclosure upon request to the Commission and its appropriate Federal banking agency, if any, until three years after all ABS interests are no longer outstanding.

#### § 101.5 Revolving master trusts.

(a) *Definitions.* For purposes of this section, the following definitions apply: *Revolving master trust* means an issuing entity that is:

(1) A master trust; and

(2) Established to issue on multiple issuance dates one or more series, classes, subclasses, or tranches of asset-backed securities all of which are collateralized by a common pool of securitized assets that will change in composition over time.

*Seller's interest* means an ABS interest or ABS interests:

(1) Collateralized by all of the securitized assets and servicing assets owned or held by the issuing entity other than assets that have been allocated as collateral only for a specific series;

(2) That is *pari passu* to each series of investors' ABS interests issued by the issuing entity with respect to the allocation of all distributions and losses with respect to the securitized assets prior to an early amortization event (as defined in the securitization transaction documents); and

(3) That adjusts for fluctuations in the outstanding principal balance of the securitized assets in the pool.

(b) *General requirement.* A sponsor satisfies the risk retention requirements of § 101.3 with respect to a securitization transaction for which the issuing entity is a revolving master trust if the sponsor retains a seller's interest of not less than

5 percent of the unpaid principal balance of all outstanding investors' ABS interests issued by the issuing entity.

(c) *Measuring and retaining the seller's interest.* The retention interest required pursuant to paragraph (b) of this section:

(1) Must meet the 5 percent test at the closing of each issuance of ABS interests by the issuing entity, and at every seller's interest measurement date specified under the securitization transaction documents, but no less than monthly, until no ABS interest in the issuing entity is held by any person not affiliated with the sponsor;

(2) May be retained by one or more wholly-owned affiliates of the sponsor, including one or more depositors of the revolving master trust.

(d) *Multi-level trusts.* (1) If one revolving master trust issues collateral certificates 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 certificates are all or a portion of the securitized assets, a sponsor may satisfy the requirements of paragraphs (b) and (c) of this section by retaining the seller's interest for the assets represented by the collateral certificates 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; and

(2) If the sponsor retains the seller's interest associated with the collateral certificates at the level of the revolving trust that issues those collateral certificates, the proportion of the seller's interest required by paragraph (b) of this section that shall be retained at that level shall equal no less than the proportion that the securitized assets represented by the collateral certificates bears to the total securitized assets in the revolving master trust that issues the ABS interests, as of each measurement date required by paragraph (c) of this section.

(e) *Offset for pool-level excess funding account.* The 5 percent seller's interest required on each measurement date by paragraph (c) of this section may be reduced on a dollar-for-dollar basis by the balance, as of such date, of an excess funding account in the form of a segregated account that:

(1) Is funded in the event of a failure to meet the minimum seller's interest requirements under the securitization transaction documents by distributions otherwise payable to the holder of the seller's interest;

(2) *Is pari passu* to each series of investors' ABS interests issued by the issuing entity with respect to the allocation of losses with respect to the securitized assets prior to an early amortization event; and

(3) 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.

(f) *Combined retention at trust and series level.* The 5 percent seller's interest required on each measurement date by paragraph (c) of this section 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, at a minimum, a corresponding percentage of the fair value of all ABS interests issued in each series, in the form of an eligible horizontal residual interest that meets the requirements of § \_\_.4, or, for so long as the revolving master trust continues to operate by issuing, on multiple issuance dates, one or more series, classes, subclasses, or tranches of asset-backed securities, all of which are collateralized by pooled securitized assets that change in composition over time, a horizontal interest meeting the following requirements:

(1) Whether certificated or uncertificated, in a single or multiple classes, subclasses, or tranches, the horizontal interest meets, individually or in the aggregate, the requirements of this paragraph (f);

(2) Each series of the revolving master trust 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 collateralizing the revolving master trust, which may according to the terms of the securitization transaction documents, include not only the series' ratable share of such cash flows but also excess cash flows available from other series;

(3) The horizontal interest's claim to any part 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;

(4) The horizontal interest has the most subordinated claim to any part of the series' share of the principal repayment cash flows.

(g) *Disclosure and record maintenance*—(1) *Disclosure.* A sponsor relying on this section shall provide, or cause to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities in the securitization transaction and, upon request, to the Commission and its appropriate Federal banking agency, if any, the following disclosure in written form under the caption "Credit Risk Retention":

(i) The value (expressed as a percentage of the unpaid principal balance of all of the investors' 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)) of the seller's interest that the sponsor will retain (or did retain) at the closing of the securitization transaction, the fair value (expressed as a percentage of the fair value of all of the investors' 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)) of any horizontal risk retention described in paragraph (f) of this section that the sponsor will retain (or did retain) at the closing of the securitization transaction, and the unpaid principal balance or fair value, as applicable (expressed as percentages of the values of all of the ABS interests issued in the securitization transaction and dollar amounts (or corresponding amounts in the foreign currency in which the ABS are issued, as applicable)) that the sponsor is required to retain pursuant to this section;

(ii) A description of the material terms of the seller's interest and of any horizontal risk retention described in paragraph (f) of this section; and

(iii) If the sponsor will retain (or did retain) any horizontal risk retention described in paragraph (f) of this section, the same information as is required to be disclosed by sponsors retaining horizontal interests pursuant to § \_\_.4(d)(i).

(2) *Record maintenance.* A sponsor must retain the disclosures required in paragraph (g)(1) of this section in written form in its records and must provide the disclosure upon request to the Commission and its appropriate Federal banking agency, if any, until three years after all ABS interests are no longer outstanding.

(h) *Early amortization of all outstanding series.* A sponsor that

organizes a revolving master trust for which all securitized assets collateralizing the trust are revolving assets, and that relies on this § \_\_.5 to satisfy the risk retention requirements of § \_\_.3, does not violate the requirements of this part if its seller's interest falls below the level required by § \_\_.5 after an event of default triggers early amortization, as specified in the securitization transaction documents, of all series of ABS interests issued by the trust to persons not affiliated with the sponsor, if:

(1) The sponsor was in full compliance with the requirements of this section on all measurement dates specified in paragraph (c) of this section prior to the event of default that triggered early amortization;

(2) The terms of the seller's interest continue to make it *pari passu* or subordinate to each series of investors' ABS interests issued by the issuing entity with respect to the allocation of all losses with respect to the securitized assets;

(3) The terms of any horizontal interest relied upon by the sponsor pursuant to paragraph (f) to offset the minimum seller's interest amount continue to require the interests to absorb losses in accordance with the terms of paragraph (f) of this section; and

(4) 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.

#### § \_\_.6 Eligible ABCP conduits.

(a) *Definitions.* For purposes of this section, the following additional definitions apply:

*100 percent liquidity coverage* means an amount equal to the outstanding balance of all ABCP issued by the conduit plus any accrued and unpaid interest without regard to the performance of the ABS interests held by the ABCP conduit and without regard to any credit enhancement.

*ABCP* means asset-backed commercial paper that has a maturity at the time of issuance not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

*ABCP conduit* means an issuing entity with respect to ABCP.

*Eligible ABCP conduit* means an ABCP conduit, *provided that:*

(1) The ABCP conduit is bankruptcy remote or otherwise isolated for insolvency purposes from the sponsor of the ABCP conduit and from any intermediate SPV;

(2) The asset-backed securities acquired by the ABCP conduit are:

(i) Collateralized solely by the following:

(A) Asset-backed securities 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;

(B) 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

(C) Interests in a revolving master trust collateralized solely by assets originated by an originator-seller or majority-owned OS affiliate and by servicing assets; and

(ii) Not collateralized by asset-backed securities (other than those described in paragraphs (2)(i)(A) through (C) of this definition), otherwise purchased or acquired by the intermediate SPV, the intermediate SPV's originator-seller, or a majority-owned OS affiliate of the originator seller; and

(iii) Acquired by the ABCP conduit in an initial issuance by or on behalf of an intermediate SPV (A) directly from the intermediate SPV, (B) from an underwriter of the securities issued by the intermediate SPV, or (C) from another person who acquired the securities directly from the intermediate SPV;

(3) The ABCP conduit is collateralized solely by asset-backed securities acquired from intermediate SPVs as described in paragraph (2) of this definition and servicing assets; and

(4) A regulated liquidity provider has entered into a legally binding commitment to provide 100 percent liquidity coverage (in the form of a lending facility, an asset purchase agreement, a repurchase agreement, or other similar arrangement) to all the ABCP issued by the ABCP conduit by lending to, purchasing ABCP issued by, or purchasing assets from, the ABCP conduit in the event that funds are required to repay maturing ABCP issued by the ABCP conduit. With respect to the 100 percent liquidity coverage, in the event that the ABCP conduit is unable for any reason to repay maturing ABCP issued by the issuing entity, the liquidity provider shall be obligated to pay an amount equal to any shortfall, and the total amount that may be due pursuant to the 100 percent liquidity coverage shall be equal to 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 and liquidity support that only funds performing receivables or performing ABS interests does not meet the requirements of this section).

*Intermediate SPV* means a special purpose vehicle that:

(1) Is a direct or indirect wholly-owned affiliate of the originator-seller;

(2) Is 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;

(3) Acquires assets that are originated by the originator-seller or its majority-owned OS affiliate from the originator-seller or majority-owned OS affiliate, or acquires asset-backed securities issued by another intermediate SPV or the original seller that are collateralized solely by such assets; and

(4) Issues asset-backed securities collateralized solely by such assets, as applicable.

*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. For purposes of this definition, 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.

*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.

*Regulated liquidity provider* means:

(1) A depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813));

(2) A bank holding company (as defined in 12 U.S.C. 1841), or a subsidiary thereof;

(3) 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

(4) 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.

(b) *In general.* An ABCP conduit sponsor satisfies the risk retention requirement of § \_\_\_\_\_.3 with respect to the issuance of ABCP by an eligible ABCP conduit in a securitization transaction if, for each ABS interest the ABCP conduit acquires from an intermediate SPV:

(1) The intermediate SPV's originator-seller retains an economic interest in the credit risk of the assets collateralizing the ABS interest acquired by the eligible ABCP conduit in accordance with paragraph (b)(2) of this section, in the same form, amount, and manner as would be required under §§ \_\_\_\_\_.4 or \_\_\_\_\_.5; and

(2) The ABCP conduit sponsor:

(i) Approves each originator-seller and any majority-owned OS affiliate permitted to sell or transfer assets, directly or indirectly, to an intermediate SPV from which an eligible ABCP conduit acquires ABS interests;

(ii) Approves each intermediate SPV from which an eligible ABCP conduit is permitted to acquire ABS interests;

(iii) Establishes criteria governing the ABS interests, and the assets underlying the ABS interests, acquired by the ABCP conduit;

(iv) Administers the ABCP conduit by monitoring the ABS interests acquired by the ABCP conduit and the assets supporting those ABS interests, arranging for debt placement, compiling monthly reports, and ensuring compliance with the ABCP conduit documents and with the ABCP conduit's credit and investment policy; and

(v) Maintains and adheres to policies and procedures for ensuring that the conditions in this paragraph (b) have been met.

(c) *Originator-seller compliance with risk retention.* The use of the risk retention option provided in this section 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 obligation, if any, to comply with its own risk retention obligations under this part.

(d) *Periodic disclosures to investors.* An ABCP conduit sponsor relying upon this section shall provide, or cause to be provided, to each purchaser of ABCP, before or contemporaneously with the first sale of ABCP to such purchaser and at least monthly thereafter, to each holder of commercial paper issued by the ABCP Conduit, in writing, each of the following items of information:

(1) The name and form of organization of the regulated liquidity provider that provides liquidity coverage to the eligible ABCP conduit, including a description of the form, amount, and nature of such liquidity coverage, and notice of any failure to fund.

(2) 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 category code (SIC Code) for the originator-seller or majority-owned OS affiliate that will retain (or has retained) pursuant to this section an interest in the securitization transaction; and

(C) A description of the form, fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and as a dollar amount (or corresponding amount in the foreign currency in which the ABS are issued, as applicable)), as applicable, and nature of such interest in accordance with the disclosure obligations in § \_\_\_\_\_.4(d).

(e) *Disclosures to regulators regarding originator-sellers and majority-owned OS affiliates.* An ABCP conduit sponsor relying upon this section shall provide, or cause to be provided, upon request, to the Commission and its appropriate Federal banking agency, if any, in writing, all of the information required to be provided to investors in paragraph (d) of this section, and the name and form of organization of each originator-seller or majority-owned OS affiliate that will retain (or has retained) pursuant to this section an interest in the securitization transaction.

(f) *Duty to comply.* (1) The ABCP conduit retaining sponsor shall be responsible for compliance with this section.

(2) An ABCP conduit retaining sponsor relying on this section:

(i) Shall maintain and adhere to policies and procedures that are reasonably designed to monitor compliance by each originator-seller and any majority-owned OS affiliate which sells assets to the eligible ABCP conduit with the requirements of paragraph (b)(1) of this section; and

(ii) In the event that the ABCP conduit sponsor determines that an originator-seller or majority-owned OS affiliate no longer complies with the requirements of paragraph (b)(1) of this section, shall:

(A) Promptly notify the holders of the ABCP, the Commission and its appropriate Federal banking agency, if any, in writing of:

(1) The name and form of organization of any originator-seller that fails to retain risk in accordance with paragraph

(b)(2)(i) of this section and the amount of asset-backed securities issued by an intermediate SPV of such originator-seller and held by the ABCP conduit;

(2) The name and form of organization of any originator-seller or majority-owned OS affiliate that hedges, directly or indirectly through an intermediate SPV, its risk retention in violation of paragraph (b)(1) of this section and the amount of asset-backed securities issued by an intermediate SPV of such originator-seller or majority-owned OS affiliate and held by the ABCP conduit; and

(3) Any remedial actions taken by the ABCP conduit sponsor or other party with respect to such asset-backed securities; and

(B) Take other appropriate steps pursuant to the requirements of paragraphs (b)(2)(iv) and (b)(2)(v) of this section which may include, as appropriate, curing any breach of the requirements in this section, or removing from the eligible ABCP conduit any asset-backed security that does not comply with the requirements in this section.

#### § \_\_\_\_\_.7 Commercial mortgage-backed securities.

(a) *Definitions.* For purposes of this section, the following definition shall apply:

*Special servicer* means, 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.

(b) *Third-Party Purchaser.* A sponsor may satisfy some or all of its risk retention requirements under § \_\_\_\_\_.3 with respect to a securitization transaction 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 would be held by the sponsor under § \_\_\_\_\_.4 and all of the following conditions are met:

(1) *Number of third-party purchasers.* At any time, there are no more than two third-party purchasers of an eligible horizontal residual interest. If there are two third-party purchasers, each third-party purchaser's interest must be *pari passu* with the other third-party purchaser's interest.

(2) *Composition of collateral.* The securitization transaction is collateralized solely by commercial real estate loans and servicing assets.

(3) *Source of funds.* (i) Each third-party purchaser pays for the eligible horizontal residual interest in cash at

the closing of the securitization transaction.

(ii) No third-party purchaser obtains 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 (including, but not limited to, the sponsor, depositor, or servicer other than a special servicer affiliated with the third-party purchaser), other than a person that is a party to the transaction solely by reason of being an investor.

(4) *Third-party review.* Each third-party purchaser conducts an independent review of the credit risk of each securitized asset prior to the sale of the asset-backed securities in the securitization transaction that includes, at a minimum, a review of the underwriting standards, collateral, and expected cash flows of each commercial real estate loan that is collateral for the asset-backed securities.

(5) *Affiliation and control rights.* (i) Except as provided in paragraph (b)(5)(ii) of this section, no third-party purchaser is affiliated with any party to the securitization transaction (including, but not limited to, the sponsor, depositor, or servicer) other than investors in the securitization transaction.

(ii) Notwithstanding paragraph (b)(5)(i) of this section, a third-party purchaser may be affiliated with:

(A) The special servicer for the securitization transaction; or

(B) One or more originators of the securitized assets, as long as the assets originated by the affiliated originator or originators collectively comprise less than 10 percent of the unpaid principal balance of the securitized assets included in the securitization transaction at closing of the securitization transaction.

(6) *Operating Advisor.* The underlying securitization transaction documents shall provide for the following:

(i) The appointment of an operating advisor (the Operating Advisor) that:

(A) Is not affiliated with other parties to the securitization transaction;

(B) Does not directly or indirectly have any financial interest in the securitization transaction other than in fees from its role as Operating Advisor; and

(C) Is required to act in the best interest of, and for the benefit of, investors as a collective whole;

(ii) Standards with respect to the Operating Advisor's experience, expertise and financial strength to fulfill its duties and responsibilities under the applicable transaction documents over the life of the securitization transaction;

(iii) The terms of the Operating Advisor's compensation with respect to the securitization transaction;

(iv) When the eligible horizontal residual interest has a principal balance of 25 percent or less of its initial principal balance, the special servicer for the securitized assets must consult with the Operating Advisor in connection with, and prior to, any material decision in connection with its servicing of the securitized assets, including, without limitation:

(A) Any material modification of, or waiver with respect to, any provision of a loan agreement (including a mortgage, deed of trust, or other security agreement);

(B) Foreclosure upon or comparable conversion of the ownership of a property; or

(C) Any acquisition of a property.

(v) The Operating Advisor shall have adequate and timely access to information and reports necessary to fulfill its duties under the transaction documents and shall be responsible for:

(A) Reviewing the actions of the special servicer;

(B) Reviewing all reports made by the special servicer to the issuing entity;

(C) Reviewing for accuracy and consistency calculations made by the special servicer with the transaction documents; and

(D) Issuing a report to investors and the issuing entity on a periodic basis concerning:

(1) Whether the Operating Advisor believes, in its sole discretion exercised in good faith, that the special servicer is operating in compliance with any standard required of the special servicer as provided in the applicable transaction documents; and

(2) With which, if any, standards the Operating Advisor believes, in its sole discretion exercised in good faith, the special servicer has failed to comply.

(vi) (A) The Operating Advisor shall have the authority to recommend that the special servicer be replaced by a successor special servicer if the Operating Advisor determines, in its sole discretion exercised in good faith, that:

(1) The special servicer has failed to comply with a standard required of the special servicer as provided in the applicable transaction documents; and

(2) Such replacement would be in the best interest of the investors as a collective whole; and

(B) If a recommendation described in paragraph (b)(6)(vi)(A) of this section is made, the special servicer shall be replaced upon the affirmative vote of a majority of the outstanding principal balance of all ABS interests voting on

the matter, with a minimum of a quorum of ABS interests voting on the matter. For purposes of such vote, the holders of 5 percent of the outstanding principal balance of all ABS interests in the issuing entity shall constitute a quorum.

(7) *Disclosures.* The sponsor provides, or causes to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities as part of the securitization transaction and, upon request, to the Commission and its appropriate Federal banking agency, if any, the following disclosure in written form under the caption "Credit Risk Retention":

(i) The name and form of organization of each initial third-party purchaser that acquired an eligible horizontal residual interest at the closing of a securitization transaction;

(ii) A description of each initial third-party purchaser's experience in investing in commercial mortgage-backed securities;

(iii) 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;

(iv) A description of the fair value (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)) of the eligible horizontal residual interest that will be retained (or was retained) by each initial third-party purchaser, as well as the amount of the purchase price paid by each initial third-party purchaser for such interest;

(v) The fair value (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)) of the eligible horizontal residual interest in the securitization transaction that the sponsor would have retained pursuant to § \_\_\_\_\_.4 if the sponsor had relied on retaining an eligible horizontal residual interest in that section to meet the requirements of § \_\_\_\_\_.3 with respect to the transaction;

(vi) A description of the material terms of the eligible horizontal residual interest retained by each initial third-party purchaser, including the same information as is required to be disclosed by sponsors retaining horizontal interests pursuant to § \_\_\_\_\_.4;

(vii) The material terms of the applicable transaction documents with respect to the Operating Advisor, including without limitation:

(A) The name and form of organization of the Operating Advisor;

(B) The standards required by paragraph (b)(6)(ii) of this section and a description of how the Operating Advisor satisfies each of the standards; and

(C) The terms of the Operating Advisor's compensation under paragraph (b)(6)(iii) of this section; and

(viii) The representations and warranties concerning the securitized assets, a schedule of any securitized assets that are determined do not comply with such representations and warranties, and what factors were used to make the determination that such securitized assets should be included in the pool notwithstanding that the securitized assets did not comply with such representations and warranties, such as compensating factors or a determination that the exceptions were not material.

(8) *Hedging, transfer and pledging—*  
(i) *General rule.* Except as set forth in paragraph (b)(8)(ii) of this section, each third-party purchaser must comply with the hedging and other restrictions in § \_\_\_\_\_.12 as if it were the retaining sponsor with respect to the securitization transaction and had acquired the eligible horizontal residual interest pursuant to § \_\_\_\_\_.4.

(ii) *Exceptions—*(A) *Transfer by initial third-party purchaser or sponsor.* An initial third-party purchaser that acquired an eligible horizontal residual interest at the closing of a securitization transaction in accordance with this section, or a sponsor that acquired an eligible horizontal residual interest at the closing of a securitization transaction in accordance with this section, may, on or after the date that is five years after the date of the closing of a securitization transaction, transfer that interest to a subsequent third-party purchaser that complies with paragraph (b)(8)(ii)(C) of this section. The initial third-party purchaser shall provide the sponsor with complete identifying information for the subsequent third-party purchaser.

(B) *Transfer by subsequent third-party purchaser.* At any time, a subsequent third-party purchaser that acquired an eligible horizontal residual interest pursuant to this paragraph (b)(8)(ii)(B) may transfer its interest to a different third-party purchaser that complies with paragraph (b)(8)(ii)(C) of this section. The transferring third-party purchaser shall provide the sponsor

with complete identifying information for the acquiring third-party purchaser.

(C) *Requirements applicable to subsequent third-party purchasers.* A subsequent third-party purchaser is subject to all of the requirements of paragraphs (b)(1), (b)(3) through (b)(5), and (b)(8) of this section applicable to third-party purchasers, provided that obligations under paragraphs (b)(1), (b)(3) through (b)(5), and (b)(8) of this section that apply to initial third-party purchasers at or before the time of closing of the securitization transaction shall apply to successor third-party purchasers at or before the time of the transfer of the eligible horizontal residual interest to the successor third-party purchaser.

(c) *Duty to comply.* (1) The retaining sponsor shall be responsible for compliance with this section by itself and by each initial or subsequent third-party purchaser that acquired an eligible horizontal residual interest in the securitization transaction.

(2) A sponsor relying on this section:

(A) Shall maintain and adhere to policies and procedures to monitor each third-party purchaser's compliance with the requirements of paragraphs (b)(1), (b)(3) through (b)(5), and (b)(8) of this section; and

(B) In the event that the sponsor determines that a third-party purchaser no longer complies with any of the requirements of paragraphs (b)(1), (b)(3) through (b)(5), or (b)(8) of this section, shall promptly notify, or cause to be notified, the holders of the ABS interests issued in the securitization transaction of such noncompliance by such third-party purchaser.

#### § \_\_.8 Federal National Mortgage Association and Federal Home Loan Mortgage Corporation ABS.

(a) *In general.* A sponsor satisfies its risk retention requirement under this part if the sponsor fully guarantees the timely payment of principal and interest on all ABS interests issued by the issuing entity in the securitization transaction and is:

(1) The Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation operating under the conservatorship or receivership of the Federal Housing Finance Agency pursuant to section 1367 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4617) with capital support from the United States; or

(2) Any limited-life regulated entity succeeding to the charter of either the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation pursuant to section 1367(i)

of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4617(i)), provided that the entity is operating with capital support from the United States.

(b) *Certain provisions not applicable.* The provisions of § \_\_.12(b), (c), and (d) shall not apply to a sponsor described in paragraph (a)(1) or (2) of this section, its affiliates, or the issuing entity with respect to a securitization transaction for which the sponsor has retained credit risk in accordance with the requirements of this section.

(c) *Disclosure.* A sponsor relying on this section shall provide to investors, in written form under the caption "Credit Risk Retention" and, upon request, to the Federal Housing Finance Agency and the Commission, a description of the manner in which it has met the credit risk retention requirements of this part.

#### § \_\_.9 Open market CLOs.

(a) *Definitions.* For purposes of this section, the following definitions shall apply:

*CLO* means a special purpose entity that:

(1) Issues debt and equity interests, and

(2) Whose assets consist primarily of loans that are securitized assets and servicing assets.

*CLO-eligible loan tranche* means a term loan of a syndicated facility that meets the criteria set forth in paragraph (c) of this section.

*CLO Manager* means an entity that manages a CLO, which entity is registered as an investment adviser under the Investment Advisers Act of 1940, as amended (15 U.S.C. 80b-1 *et seq.*), or is an affiliate of such a registered investment adviser and itself is managed by such registered investment adviser.

*Commercial borrower* means an obligor under a corporate credit obligation (including a loan).

*Initial loan syndication transaction* means a transaction in which a loan is syndicated to a group of lenders.

*Lead arranger* means, with respect to a CLO-eligible loan tranche, an institution that:

(1) Is active in the origination, structuring and syndication of commercial loan transactions (as defined in § \_\_.14) and has played a primary role in the structuring, underwriting and distribution on the primary market of the CLO-eligible loan tranche.

(2) Has taken an allocation of the syndicated credit facility under the terms of the transaction that includes the CLO-eligible loan tranche of at least

20 percent of the aggregate principal balance at origination, and no other member (or members affiliated with each other) of the syndication group at origination has taken a greater allocation; and

(3) Is identified at the time of origination in the credit agreement and any intercreditor or other applicable agreements governing the CLO-eligible loan tranche; represents therein to the holders of the CLO-eligible loan tranche and to any holders of participation interests in such CLO-eligible loan tranche that such lead arranger and the CLO-eligible loan tranche satisfy the requirements of this section; and covenants therein to such holders that such lead arranger will fulfill the requirements of clause (i) of the definition of CLO-eligible loan tranche.

*Open market CLO* means a CLO:

(1) Whose assets consist of senior, secured syndicated loans acquired by such CLO directly from the sellers thereof in open market transactions and of servicing assets,

(2) That is managed by a CLO manager, and

(3) 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.

*Open market transaction* means:

(1) Either an initial loan syndication transaction or a secondary market transaction in which a seller offers senior, secured syndicated loans to prospective purchasers in the loan market on market terms on an arm's length basis, which prospective purchasers include, but are not limited to, entities that are not affiliated with the seller, or

(2) A reverse inquiry from a prospective purchaser of a senior, secured syndicated loan through a dealer in the loan market to purchase a senior, secured syndicated loan to be sourced by the dealer in the loan market.

*Secondary market transaction* means a purchase of a senior, secured syndicated loan not in connection with an initial loan syndication transaction but in the secondary market.

*Senior, secured syndicated loan* means a loan made to a commercial borrower that:

(1) Is not subordinate in right of payment to any other obligation for borrowed money of the commercial borrower,

(2) Is secured by a valid first priority security interest or lien in or on specified collateral securing the

commercial borrower's obligations under the loan, and

(3) The value of the collateral subject to such first priority security interest or lien, together with other attributes of the obligor (including, without limitation, its general financial condition, ability to generate cash flow available for debt service and other demands for that cash flow), is adequate (in the commercially reasonable judgment of the CLO manager exercised at the time of investment) to repay the loan in accordance with its terms and to repay all other indebtedness of equal seniority secured by such first priority security interest or lien in or on the same collateral, and the CLO manager certifies as to the adequacy of the collateral and attributes of the borrower under this paragraph in regular periodic disclosures to investors.

(b) *In general.* A sponsor satisfies the risk retention requirements of § \_\_\_\_ .3 with respect to an open market CLO transaction if:

(1) The open market CLO does not acquire or hold any assets other than CLO-eligible loan tranches that meet the requirements of paragraph (c) of this section and servicing assets;

(2) The governing documents of such open market CLO require that, at all times, the assets of the open market CLO consist of senior, secured syndicated loans that are CLO-eligible loan tranches and servicing assets;

(3) The open market CLO does not invest in ABS interests or in credit derivatives other than hedging transactions that are servicing assets to hedge risks of the open market CLO;

(4) All purchases of CLO-eligible loan tranches and other assets by the open market CLO issuing entity or through a warehouse facility used to accumulate the loans prior to the issuance of the CLO's ABS interests are made in open market transactions on an arms-length basis;

(5) The CLO Manager of the open market CLO is not entitled to receive any management fee or gain on sale at the time the open market CLO issues its ABS interests.

(c) *CLO-eligible loan tranche.* To qualify as a CLO-eligible loan tranche, a term loan of a syndicated credit facility to a commercial borrower must have the following features:

(1) A minimum of 5 percent of the face amount of the CLO-eligible loan tranche is retained by the lead arranger thereof until the earliest of the repayment, maturity, involuntary and unscheduled acceleration, payment default, or bankruptcy default of such CLO-eligible loan tranche, provided that such lead arranger complies with

limitations on hedging, transferring and pledging in § \_\_\_\_ .12 with respect to the interest retained by the lead arranger.

(2) Lender voting rights within the credit agreement and any intercreditor or other applicable agreements governing such CLO-eligible loan tranche are defined so as to give holders of the CLO-eligible loan tranche consent rights with respect to, at minimum, any material waivers and amendments of such applicable documents, including but not limited to, adverse changes to money terms, alterations to *pro rata* provisions, changes to voting provisions, and waivers of conditions precedent; and

(3) The *pro rata* provisions, voting provisions, and similar provisions applicable to the security associated with such CLO-eligible loan tranches under the CLO credit agreement and any intercreditor or other applicable agreements governing documents such 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.

(d) *Disclosures.* A sponsor relying on this section shall provide, or cause to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities in the securitization transaction and at least annually with respect to the information required by paragraph (d)(1) of this section and, upon request, to the Commission and its appropriate Federal banking agency, if any, the following disclosure in written form under the caption "Credit Risk Retention":

(1) *Open market CLOs.* A complete list of every asset held by an open market CLO (or before the CLO's closing, in a warehouse facility in anticipation of transfer into the CLO at closing), including the following information:

(i) The full legal name and Standard Industrial Classification (SIC) category code of the obligor of the loan or asset;

(ii) The full name of the specific loan tranche held by the CLO;

(iii) The face amount of the loan tranche held by the CLO;

(iv) The price at which the loan tranche was acquired by the CLO; and

(v) For each loan tranche, the full legal name of the lead arranger subject to the sales and hedging restrictions of § \_\_\_\_ .12 and the; and

(2) *CLO manager.* The full legal name and form of organization of the CLO manager.

#### § \_\_\_\_ .10 Qualified tender option bonds.

(a) *Definitions.* For purposes of this section, the following definitions shall apply:

*Municipal security or municipal securities* shall have the same meaning as municipal securities in Section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29)) and any rules promulgated pursuant to such section.

*Qualified tender option bond entity* means an issuing entity with respect to tender option bonds for which each of the following applies:

(1) Such entity is collateralized solely by servicing assets and municipal securities 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.

(2) Such entity issues no securities other than:

(i) a single class of tender option bonds with a preferred variable return payable out of capital that meets the requirements of paragraph (b) of this section and

(ii) a single residual equity interest that is entitled to all remaining income of the TOB issuing entity. Both of these types of securities must constitute "asset-backed securities" as defined in Section 3(a)(79) of the Exchange Act (15 U.S.C. 78c(a)(79)).

(3) The municipal securities held as assets by such entity are issued in compliance with Section 103 of the Internal Revenue Code of 1986, as amended (the "IRS Code", 26 U.S.C. 103), such that the interest payments made on those securities are excludable from the gross income of the owners under Section 103 of the IRS Code.

(4) The holders of all of the securities issued by such entity are eligible to receive interest that is excludable from gross income pursuant to Section 103 of the IRS Code or "exempt-interest dividends" pursuant to Section 852(b)(5) of the IRS Code (26 U.S.C. 852(b)(5)) in the case of regulated investment companies under the Investment Company Act of 1940, as amended.

(5) Such entity has a legally binding commitment from a regulated liquidity provider as defined in § \_\_\_\_ .6(a), to provide a 100 percent guarantee or liquidity coverage with respect to all of the issuing entity's outstanding tender option bonds.

(6) Such entity qualifies for monthly closing elections pursuant to IRS Revenue Procedure 2003-84, as amended or supplemented from time to time.

*Tender option bond* means a security which:

(1) Has features which entitle the holders to tender such bonds to the TOB issuing entity for purchase at any time upon no more than 30 days' notice, for a purchase price equal to the approximate amortized cost of the security, plus accrued interest, if any, at the time of tender; and

(2) Has all necessary features so such security qualifies for purchase by money market funds under Rule 2a-7 under the Investment Company Act of 1940, as amended.

(b) *Standard risk retention.*

Notwithstanding anything in this section, the sponsor with respect to an issuance of tender option bonds by a qualified tender option bond entity may retain an eligible vertical interest or eligible horizontal residual interest, or any combination thereof, in accordance with the requirements of § \_\_\_\_\_.4.

(c) *Tender option termination event.*

The sponsor with respect to an issuance of tender option bonds by a qualified tender option bond entity may retain 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, as amended or supplemented from time to time will meet requirements of an eligible vertical interest.

(d) *Retention of a municipal security outside of the qualified tender option bond entity.* The sponsor with respect to an issuance of tender option bonds by a qualified tender option bond entity may satisfy their risk retention requirements under this Section by 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.

(e) *Disclosures.* The sponsor provides, or causes to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities as part of the securitization transaction and, upon request, to the Commission and its appropriate Federal banking agency, if any, the following disclosure in written form under the caption "Credit Risk Retention" the name and form of organization of the qualified tender option bond entity, and a description of the form, fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and as a dollar amount), and nature of such

interest in accordance with the disclosure obligations in § \_\_\_\_\_.4(d).

(f) *Prohibitions on Hedging and Transfer.* The prohibitions on transfer and hedging set forth in § \_\_\_\_\_.12, apply to any municipal securities retained by the sponsor with respect to an issuance of tender option bonds by a qualified tender option bond entity pursuant to paragraph (d) of this section.

### Subpart C—Transfer of Risk Retention

#### § \_\_\_\_\_.11 Allocation of risk retention to an originator.

(a) *In general.* A sponsor choosing to retain an eligible vertical interest or an eligible horizontal residual interest (including an eligible horizontal cash reserve account), or combination thereof under § \_\_\_\_\_.4, with respect to a securitization transaction may offset the amount of its risk retention requirements under § \_\_\_\_\_.4 by the amount of the eligible interests, respectively, acquired by an originator of one or more of the securitized assets if:

(1) At the closing of the securitization transaction:

(i) The originator acquires the eligible interest from the sponsor and retains such interest in the same manner as the sponsor under § \_\_\_\_\_.4, as such interest was held prior to the acquisition by the originator;

(ii) 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 pursuant to § \_\_\_\_\_.4, does not exceed the ratio of:

(A) The unpaid principal balance of all the securitized assets originated by the originator; to

(B) The unpaid principal balance of all the securitized assets in the securitization transaction;

(iii) The originator acquires and retains at least 20 percent of the aggregate risk retention amount otherwise required to be retained by the sponsor pursuant to § \_\_\_\_\_.4; and

(iv) 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 in accordance with this section, by payment to the sponsor in the form of:

(A) Cash; or

(B) A reduction in the price received by the originator from the sponsor or depositor for the assets sold by the originator to the sponsor or depositor for inclusion in the pool of securitized assets.

(2) *Disclosures.* In addition to the disclosures required pursuant to

§ \_\_\_\_\_.4(d), the sponsor provides, or causes to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities as part of the securitization transaction and, upon request, to the Commission and its appropriate Federal banking agency, if any, in written form under the caption "Credit Risk Retention", the name and form of organization of any originator that will acquire and retain (or has acquired and retained) an interest in the transaction pursuant to this section, including a description of the form, amount (expressed as a percentage and dollar amount (or corresponding amount in the foreign currency in which the ABS are issued, as applicable)), and nature of the interest, as well as the method of payment for such interest under paragraph (a)(1)(iv) of this section.

(3) *Hedging, transferring and pledging.* The originator complies with the hedging and other restrictions in § \_\_\_\_\_.12 with respect to the interests retained by the originator pursuant to this section as if it were the retaining sponsor and was required to retain the interest under subpart B of this part.

(b) *Duty to comply.* (1) The retaining sponsor shall be responsible for compliance with this section.

(2) A retaining sponsor relying on this section:

(A) Shall maintain and adhere to policies and procedures that are reasonably designed to monitor the compliance by each originator that is allocated a portion of the sponsor's risk retention obligations with the requirements in paragraphs (a)(1) and (a)(3) of this section; and

(B) In the event the sponsor determines that any such originator no longer complies with any of the requirements in paragraphs (a)(1) and (a)(3) of this section, shall promptly notify, or cause to be notified, the holders of the ABS interests issued in the securitization transaction of such noncompliance by such originator.

#### § \_\_\_\_\_.12 Hedging, transfer and financing prohibitions.

(a) *Transfer.* A retaining sponsor may not sell or otherwise transfer any interest or assets that the sponsor is required to retain pursuant to subpart B of this part to any person other than an entity that is and remains a majority-owned affiliate of the sponsor.

(b) *Prohibited hedging by sponsor and affiliates.* A retaining sponsor and its affiliates may not purchase or sell a security, or other financial instrument, or enter into an agreement, derivative or other position, with any other person if:

(1) Payments on the security or other financial instrument or under the agreement, derivative, or position are materially related to the credit risk of one or more particular ABS interests that the retaining sponsor is required to retain with respect to a securitization transaction pursuant to subpart B of this part or one or more of the particular securitized assets that collateralize the asset-backed securities issued in the securitization transaction; and

(2) The security, instrument, agreement, derivative, or position in any way reduces or limits the financial exposure of the sponsor to the credit risk of one or more of the particular ABS interests that the retaining sponsor is required to retain with respect to a securitization transaction pursuant to subpart B of this part or one or more of the particular securitized assets that collateralize the asset-backed securities issued in the securitization transaction.

(c) *Prohibited hedging by issuing entity.* The issuing entity in a securitization transaction may not purchase or sell a security or other financial instrument, or enter into an agreement, derivative or position, with any other person if:

(1) Payments on the security or other financial instrument or under the agreement, derivative or position are materially related to the credit risk of one or more particular ABS interests that the retaining sponsor for the transaction is required to retain with respect to the securitization transaction pursuant to subpart B of this part; and

(2) The security, instrument, agreement, derivative, or position in any way reduces or limits the financial exposure of the retaining sponsor to the credit risk of one or more of the particular ABS interests that the sponsor is required to retain pursuant to subpart B of this part.

(d) *Permitted hedging activities.* The following activities shall not be considered prohibited hedging activities under paragraph (b) or (c) of this section:

(1) Hedging the interest rate risk (which does not include the specific interest rate risk, known as spread risk, associated with the ABS interest that is otherwise considered part of the credit risk) or foreign exchange risk arising from one or more of the particular ABS interests required to be retained by the sponsor under subpart B of this part or one or more of the particular securitized assets that underlie the asset-backed securities issued in the securitization transaction; or

(2) Purchasing or selling a security or other financial instrument or entering into an agreement, derivative, or other

position with any third party where payments on the security or other financial instrument or under the agreement, derivative, or position are based, directly or indirectly, on an index of instruments that includes asset-backed securities if:

(i) 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

(ii) All classes of ABS interests in all issuing entities that were issued in connection with any securitization transaction in which the sponsor was required to retain an interest pursuant to subpart B of this part 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.

(e) *Prohibited non-recourse financing.* Neither a retaining sponsor nor any of its affiliates may pledge as collateral for any obligation (including a loan, repurchase agreement, or other financing transaction) any ABS interest that the sponsor is required to retain with respect to a securitization transaction pursuant to subpart B of this part unless such obligation is with full recourse to the sponsor or affiliate, respectively.

(f) *Duration of the hedging and transfer restrictions—(1) General rule.* Except as provided in paragraph (f)(2) of this section, the prohibitions on sale and hedging pursuant to paragraphs (a) and (b) of this section shall 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 of the securitization transaction;

(ii) The date on which the total unpaid principal obligations under the ABS interests issued in the securitization transaction has been reduced to 33 percent of the total unpaid principal obligations of the ABS interests at closing of the securitization transaction; or

(iii) Two years after the date of the closing of the securitization transaction.

(2) *Securitized residential mortgages.* (i) If all of the assets that

collateralize a securitization transaction subject to risk retention under this part are residential mortgages, the prohibitions on sale and hedging pursuant to paragraphs (a) and (b) of this section shall expire on or after the date that is the later of:

(A) Five years after the date of the closing of the securitization transaction; or

(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 at the closing of the securitization transaction.

(ii) Notwithstanding paragraph (f)(2)(i) of this section, the prohibitions on sale and hedging pursuant to paragraphs (a) and (b) of this section shall expire with respect to the sponsor of a securitization transaction described in paragraph (f)(2)(i) of this section on or after the date that is seven years after the date of the closing of the securitization transaction.

(3) *Conservatorship or receivership of sponsor.* A conservator or receiver of the sponsor (or any other person holding risk retention pursuant to this part) of a securitization transaction is permitted to sell or hedge any economic interest in the 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 Federal Deposit Insurance Corporation, or an agency or instrumentality of the United States or of a State as conservator or receiver, including without limitation any of the following authorities:

- (i) 12 U.S.C. 1811;
- (ii) 12 U.S.C. 1787;
- (iii) 12 U.S.C. 4617; or
- (iv) 12 U.S.C. 5382.

#### Subpart D—Exceptions and Exemptions

##### § .13 Exemption for qualified residential mortgages.

(a) *Definitions.* For purposes of this section, the following definitions shall apply:

*Currently performing* means the borrower in the mortgage transaction is not currently thirty (30) days past due, in whole or in part, on the mortgage transaction.

*Qualified residential mortgage* means a “qualified mortgage” as defined in section 129 C of the Truth in Lending Act (15 U.S.C. 1639c) and regulations issued thereunder.

(b) *Exemption.* A sponsor shall be exempt from the risk retention

requirements in subpart B of this part with respect to any securitization transaction, if:

(1) All of the assets that collateralize the asset-backed securities are qualified residential mortgages or servicing assets;

(2) None of the assets that collateralize the asset-backed securities are other asset-backed securities;

(3) At the closing of the securitization transaction, each qualified residential mortgage collateralizing the asset-backed securities is currently performing; and

(4)(i) The depositor of the asset-backed security certifies that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the asset-backed security are qualified residential mortgages or servicing assets and has concluded that its internal supervisory controls are effective; and

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

(iii) The sponsor provides, or causes to be provided, a copy of the certification described in paragraph (b)(4)(i) of this section to potential investors a reasonable period of time prior to the sale of asset-backed securities in the issuing entity, and, upon request, to the Commission and its appropriate Federal banking agency, if any.

(c) *Repurchase of loans subsequently determined to be non-qualified after closing.* A sponsor that has relied on the exemption provided in paragraph (b) of this section with respect to a securitization transaction shall not lose such exemption with respect to such transaction if, after closing of the securitization transaction, it is determined that one or more of the residential mortgage loans collateralizing the asset-backed securities does not meet all of the criteria to be a qualified residential mortgage *provided that*:

(1) The depositor complied with the certification requirement set forth in paragraph (b)(4) of this section;

(2) The sponsor repurchases the loan(s) from the issuing entity at a price at least equal to the remaining aggregate unpaid principal balance and accrued interest on the loan(s) no later than 90 days after the determination that the

loans do not satisfy the requirements to be a qualified residential mortgage; and

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

**§ \_\_\_\_ .14 Definitions applicable to qualifying commercial loans, qualifying commercial real estate loans, and qualifying automobile loans.**

The following definitions apply for purposes of §§ \_\_\_\_ .15 through \_\_\_\_ .18:

*Appraisal Standards Board* means the board of the Appraisal Foundation that establishes generally accepted standards for the appraisal profession.

*Automobile loan*: (1) Means 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; and

(2) 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.

*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:

(1) For acquisition funding, the lesser of the purchase price or the estimated market value of the real property based on an appraisal that meets the requirements set forth in § \_\_\_\_ .17(a)(2)(ii); or

(2) For refinancing, the estimated market value of the real property based on an appraisal that meets the requirements set forth in § \_\_\_\_ .17(a)(2)(ii).

*Commercial loan* means a secured 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) Commercial real estate loan.

*Commercial real estate (CRE) loan*: (1) Means 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; and

(2) Does not include:

(i) A land development and construction loan (including 1- to 4-family residential or commercial construction loans);

(ii) Any other land loan; or

(iii) An unsecured loan to a developer.

*Debt service coverage (DSC) ratio* means:

(1) For qualifying leased CRE loans, qualifying multi-family loans, and other CRE loans:

(i) The annual NOI less the annual replacement reserve of the CRE property at the time of origination of the CRE loans divided by

(ii) The sum of the borrower's annual payments for principal and interest on any debt obligation.

(2) For commercial loans:

(i) The borrower's EBITDA as of the most recently completed fiscal year divided by

(ii) The sum of the borrower's annual payments for principal and interest on all debt obligations.

*Debt to income (DTI) ratio* means the borrower's total debt, including the monthly amount due on the automobile loan, divided by the borrower's monthly income.

*Earnings before interest, taxes, depreciation, and amortization (EBITDA)* means the annual income of a business before expenses for interest, taxes, depreciation and amortization are deducted, as determined in accordance with GAAP.

*Environmental risk assessment* means a process for determining whether a property is contaminated or exposed to any condition or substance that could result in contamination that has an adverse effect on the market value of the property or the realization of the collateral value.

*First lien* means a lien or encumbrance on property that has priority over all other liens or encumbrances on the property.

*Junior lien* means a lien or encumbrance on property that is lower in priority relative to other liens or encumbrances on the property.

*Leverage ratio* means the borrower's total debt divided by the borrower's EBITDA.

*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:

(1) For acquisition funding, the lesser of the purchase price or the estimated market value of the real property based on an appraisal that meets the requirements set forth in § \_\_\_\_ .17(a)(2)(ii); or

(2) For refinancing, the estimated market value of the real property based on an appraisal that meets the requirements set forth in § \_\_\_\_ .17(a)(2)(ii).

*Model year* means the year determined by the manufacturer and reflected on the vehicle's Motor Vehicle Title as part of the vehicle description.

*Net operating income (NOI)* refers to the income a CRE property generates for the borrower after all expenses have been deducted for federal income tax purposes, except for depreciation, debt service expenses, and federal and State income taxes, and excluding any unusual and nonrecurring items of income.

*Operating affiliate* means an affiliate of a borrower that is a lessor or similar party with respect to the commercial real estate securing the loan.

*Payments-in-kind* means payments of principal or accrued interest that are not paid in cash when due, and instead are paid by increasing the principal balance of the loan or by providing equity in the borrowing company.

*Purchase money security interest* means a security interest in property that secures the obligation of the obligor incurred as all or part of the price of the property.

*Purchase price* means the amount paid by the borrower for the vehicle net of any incentive payments or manufacturer cash rebates.

*Qualified tenant* means:

(1) A tenant with a lease who has satisfied all obligations with respect to the property in a timely manner; or

(2) 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.

*Qualifying leased CRE loan* means a CRE loan secured by commercial nonfarm real property, other than a multi-family property or a hotel, inn, or similar property:

(1) That is occupied by one or more qualified tenants pursuant to a lease

agreement with a term of no less than one (1) month; and

(2) Where no more than 20 percent of the aggregate gross revenue of the property is payable from one or more tenants who:

(i) Are subject to a lease that will terminate within six months following the date of origination; or

(ii) Are not qualified tenants.

*Qualifying multi-family 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):

(1) That consists of five or more dwelling units (including apartment buildings, condominiums, cooperatives and other similar structures) primarily for residential use; and

(2) Where at least 75 percent of the NOI 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.

*Rental income* means:

(1) Income derived from a lease or other occupancy agreement between the borrower or an operating affiliate of the borrower and a party which is not an affiliate of the borrower for the use of real property or improvements serving as collateral for the applicable loan, and

(2) Other income derived from hotel, motel, dormitory, nursing home, assisted living, mini-storage warehouse or similar properties that are used primarily by parties that are not affiliates or employees of the borrower or its affiliates.

*Replacement reserve* means the monthly capital replacement or maintenance amount based on the property type, age, construction and condition of the property that is adequate to maintain the physical condition and NOI of the property.

*Salvage title* means a form of vehicle title branding, which notes that the vehicle has been severely damaged and/or deemed a total loss and uneconomical to repair by an insurance company that paid a claim on the vehicle.

*Total debt*, with respect to a borrower, means:

(1) In the case of an automobile loan, the sum of:

(i) All monthly housing payments (rent- or mortgage-related, including property taxes, insurance and home owners association fees); and

(ii) Any of the following that are dependent upon the borrower's income for payment:

(A) Monthly payments on other debt and lease obligations, such as credit

card loans or installment loans, including the monthly amount due on the automobile loan;

(B) Estimated monthly amortizing payments for any term debt, debts with other than monthly payments and debts not in repayment (such as deferred student loans, interest-only loans); and

(C) Any required monthly alimony, child support or court-ordered payments; and

(2) In the case of a commercial loan, the outstanding balance of all long-term debt (obligations that have a remaining maturity of more than one year) and the current portion of all debt that matures in one year or less.

*Total liabilities ratio* means the borrower's total liabilities, determined in accordance with GAAP divided by the sum of the borrower's total liabilities and equity, less the borrower's intangible assets, with each component determined in accordance with GAAP.

*Trade-in allowance* means the amount a vehicle purchaser is given as a credit at the purchase of a vehicle for the fair exchange of the borrower's existing vehicle to compensate the dealer for some portion of the vehicle purchase price, not to exceed the highest trade-in value of the existing vehicle, as determined by a nationally recognized automobile pricing agency and based on the manufacturer, year, model, features, mileage, and condition of the vehicle, less the payoff balance of any outstanding debt collateralized by the existing vehicle.

*Uniform Standards of Professional Appraisal Practice* means the standards issued by the Appraisal Standards Board for the performance of an appraisal, an appraisal review, or an appraisal consulting assignment.

#### **§ \_\_\_\_ .15 Qualifying commercial loans, commercial real estate loans, and automobile loans.**

(a) *General exception for qualifying assets.* Commercial loans, commercial real estate loans, and automobile loans that are securitized through a securitization transaction shall be subject to a 0 percent risk retention requirement under subpart B, provided that the following conditions are met:

(1) The assets meet the underwriting standards set forth in §§ \_\_\_\_ .16 (qualifying commercial loans), \_\_\_\_ .17 (qualifying CRE loans), or \_\_\_\_ .18 (qualifying automobile loans) of this part, as applicable;

(2) The securitization transaction is collateralized solely by loans of the same asset class and by servicing assets;

(3) The securitization transaction does not permit reinvestment periods; and

(4) The sponsor provides, or causes to be provided, to potential investors a

reasonable period of time prior to the sale of asset-backed securities of the issuing entity, and, upon request, to the Commission, and to its appropriate Federal banking agency, if any, in written form under the caption "Credit Risk Retention":

(i) 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

(ii) Descriptions of the qualifying commercial loans, qualifying CRE loans, and qualifying automobile loans (qualifying assets) and descriptions of the assets that are not qualifying assets, and the material differences between the group of qualifying assets and the group of assets that are not qualifying assets with respect to the composition of each group's loan balances, loan terms, interest rates, borrower credit information, and characteristics of any loan collateral.

(b) *Risk retention requirement.* For any securitization transaction described in paragraph (a) of this section, the amount of risk retention required under § \_\_\_\_.3(b)(1) is reduced by the same amount as the ratio of the unpaid principal balance of the qualifying commercial loans, qualifying CRE loans, or qualifying automobile loans (as applicable) to the total unpaid principal balance of commercial loans, CRE loans, or automobile loans (as applicable) that are included in the pool of assets collateralizing the asset-backed securities issued pursuant to the securitization transaction (the qualifying asset ratio); provided that:

(1) The qualifying asset ratio is measured as of the cut-off date or similar date for establishing the composition of the pool assets collateralizing the asset-backed securities issued pursuant to the securitization transaction; and

(2) The qualifying asset ratio does not exceed 50 percent.

(c) *Exception for securitizations of qualifying assets only.* Notwithstanding other provisions of this section, the risk retention requirements of subpart B of this part shall not apply to securitization transactions where the transaction is collateralized solely by servicing assets and either qualifying commercial loans, qualifying CRE loans, or qualifying automobile loans.

**§ \_\_\_\_.16 Underwriting standards for qualifying commercial loans.**

(a) *Underwriting, product and other standards.* (1) Prior to origination of the commercial loan, the originator:

(i) Verified and documented the financial condition of the borrower:

(A) As of the end of the borrower's two most recently completed fiscal years; and

(B) During the period, if any, since the end of its most recently completed fiscal year;

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

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

(A) A total liabilities ratio of 50 percent or less;

(B) A leverage ratio of 3.0 or less; and

(C) A DSC ratio of 1.5 or greater;

(iv) Determined 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:

(A) A total liabilities ratio of 50 percent or less;

(B) A leverage ratio of 3.0 or less; and

(C) A DSC ratio of 1.5 or greater.

(2) Prior to, upon or promptly following the inception of the loan, the originator:

(i) If the loan is originated on a secured basis, obtains 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, obtains a first lien on the property.

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

(i) Require the borrower to provide to the servicer of the commercial loan the borrower's financial statements and supporting schedules on an ongoing basis, but not less frequently than quarterly;

(ii) Prohibit the borrower from retaining or entering into a debt arrangement that permits payments-in-kind;

(iii) Impose limits on:

(A) The creation or existence of any other security interest or lien with respect to any of the borrower's property that serves as collateral for the loan;

(B) The transfer of any of the borrower's assets that serve as collateral for the loan; and

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

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

(A) Maintain insurance that protects against loss on the collateral for the commercial loan at least up to the amount of the loan, and that names the originator or any subsequent holder of the loan as an additional insured or loss payee;

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

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

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

(E) Maintain the physical condition of any collateral for the commercial loan.

(4) Loan payments required under the loan agreement are:

(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) To be made no less frequently than quarterly over a term that does not exceed five years.

(5) The primary source of repayment for the loan is revenue from the business operations of the borrower.

(6) The loan was funded within the six (6) months prior to the closing of the securitization transaction.

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

(8)(i) The depositor of the asset-backed security certifies that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all qualifying commercial loans that collateralize the asset-backed security and that reduce the sponsor's risk retention requirement under § \_\_\_\_.15 meet all of the requirements set forth in paragraphs (a)(1) through (a)(7) of this section and has concluded that its internal supervisory controls are effective;

(ii) The evaluation of the effectiveness of the depositor's internal supervisory controls referenced in paragraph (a)(8)(i)

of this section shall be performed, for each issuance of an asset-backed security, as of a date within 60 days of the cut-off date or similar date for establishing the composition of the asset pool collateralizing such asset-backed security; and

(iii) The sponsor provides, or causes to be provided, a copy of the certification described in paragraph (a)(8)(i) of this section to potential investors a reasonable period of time prior to the sale of asset-backed securities in the issuing entity, and, upon request, to its appropriate Federal banking agency, if any.

(b) *Cure or buy-back requirement.* If a sponsor has relied on the exception provided in § \_\_\_\_\_.15 with respect to a qualifying commercial loan and it is subsequently determined that the loan did not meet all of the requirements set forth in paragraphs (a)(1) through (a)(7) of this section, the sponsor shall not lose the benefit of the exception with respect to the commercial loan if the depositor complied with the certification requirement set forth in paragraph (a)(8) of this section and:

(1) The failure of the loan to meet any of the requirements set forth in paragraphs (a)(1) through (a)(7) of this section is not material; or

(2) No later than 90 days after the determination that the loan does not meet one or more of the requirements of paragraphs (a)(1) through (a)(7) of this section, the sponsor:

(i) Effectuates cure, establishing conformity of the loan to the unmet requirements as of the date of 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.

(3) If the sponsor cures or repurchases pursuant to paragraph (b)(2) of this section, the sponsor must promptly notify, or cause to be notified, the holders of the asset-backed securities issued in the securitization transaction of any loan(s) included in such securitization transaction that is required to be cured or repurchased by the sponsor pursuant to paragraph (b)(2) of this section, including the principal amount of such loan(s) and the cause for such cure or repurchase.

**§ \_\_\_\_\_.17 Underwriting standards for qualifying CRE loans.**

(a) *Underwriting, product and other standards.* (1) The CRE loan must be secured by the following:

(i) An enforceable first lien, documented and recorded appropriately pursuant to applicable law, on the

commercial real estate and improvements;

(ii)(A) An assignment of:

(1) Leases and rents and other occupancy agreements related to the commercial real estate or improvements or the operation thereof for which the borrower or an operating affiliate is a lessor or similar party and all payments under such leases and occupancy agreements; and

(2) All franchise, license 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 grantor or similar party and all payments under such other agreements, whether the assignments described in this paragraph (a)(1)(ii)(A)(2) are absolute or are stated to be made to the extent permitted by the agreements governing the applicable franchise, license or concession agreements;

(B) An assignment of all other payments due to the borrower or due to any operating affiliate in connection with the operation of the property described in paragraph (a)(1)(i) of this section; and

(C) The right to enforce the agreements described in paragraph (a)(1)(ii)(A) of this section and the agreements under which payments under paragraph (a)(1)(ii)(B) of this section are due against, and collect amounts due from, each lessee, occupant or other obligor whose payments were assigned pursuant to paragraphs (a)(1)(ii)(A) or (a)(1)(ii)(B) of this section upon a breach by the borrower of any of the terms of, or the occurrence of any other event of default (however denominated) under, the loan documents relating to such CRE loan; and

(iii) A security interest:

(A) In all interests of the borrower and any applicable operating affiliate in all tangible and intangible personal property of any kind, in or used in the operation of or in connection with, pertaining to, arising from, or constituting, any of the collateral described in paragraphs (a)(1)(i) or (a)(1)(ii) of this section; and

(B) In the form of a perfected security interest if the security interest in such property can be perfected by the filing of a financing statement, fixture filing, or similar document pursuant to the law governing the perfection of such security interest;

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

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

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

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

(B) Conforms to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice promulgated by the Appraisal Standards Board and the appraisal requirements<sup>1</sup> of the Federal banking agencies; and

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

(iii) Qualified the borrower for the CRE loan based on a monthly payment amount derived from a straight-line amortization of principal and interest over the term of the loan, not exceeding 25 years, or 30 years for a qualifying multi-family property;

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

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

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

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

(B) A DSC ratio of 1.25 or greater, if the loan is a qualifying multi-family property loan; or

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

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

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

(B) A DSC ratio of 1.25 or greater, if the loan is a qualifying multi-family property loan; or

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

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

(i) Require the borrower to provide the borrower's financial statements and

<sup>1</sup> 12 CFR part 34, subpart C (OCC); 12 CFR part 208, subpart E, and 12 CFR part 225, subpart G (Board); and 12 CFR part 323 (FDIC).

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; and

(ii) Impose prohibitions on:

(A) The creation or existence of any other security interest with respect to the collateral for the CRE loan described in paragraphs (a)(1)(i) and (a)(1)(ii)(A) of this section, except as provided in paragraph (a)(4) of this section;

(B) The transfer of any collateral for the CRE loan described in paragraph (b)(1)(i) or (b)(1)(ii)(A) of this section or of any other collateral consisting of fixtures, furniture, furnishings, machinery or equipment other than any such fixture, furniture, furnishings, machinery or equipment that is obsolete or surplus; and

(C) Any change to the name, location or organizational structure of any borrower, operating affiliate or other pledgor unless such borrower, operating affiliate or other pledgor shall have given the holder of the loan at least 30 days advance notice and, pursuant to applicable law governing perfection and priority, the holder of the loan is able to take all steps necessary to continue its perfection and priority during such 30-day period.

(iii) Require each borrower and each operating affiliate to:

(A) Maintain insurance that protects against loss on collateral for the CRE loan described in paragraph (a)(1)(i) of this section at least up to the amount of the loan, and names the originator or any subsequent holder of the loan as an additional insured or loss payee;

(B) Pay taxes, charges, fees, and claims, where non-payment might give rise to a lien on collateral for the CRE loan described in paragraphs (a)(1)(i) and (a)(1)(ii) of this section;

(C) Take any action required to:

(1) protect the security interest and the enforceability and priority thereof in the collateral described in paragraph (a)(1)(i) and (a)(1)(ii)(A) of this section and defend such collateral against claims adverse to the originator's or any subsequent holder's interest; and

(2) perfect the security interest of the originator or any subsequent holder of the loan in any other collateral for the CRE loan to the extent that such security interest is required by this section to be perfected;

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

(E) Maintain the physical condition of collateral for the CRE loan described in paragraph (a)(1)(i) of this section;

(F) Comply with all environmental, zoning, building code, licensing and other laws, regulations, agreements, covenants, use restrictions, and proffers applicable to collateral for the CRE loan described in paragraph (a)(1)(i) of this section;

(G) Comply with leases, franchise agreements, condominium declarations, and other documents and agreements relating to the operation of collateral for the CRE loan described in paragraph (a)(1)(i) of this section, and to not modify any material terms and conditions of such agreements over the term of the loan without the consent of the originator or any subsequent holder of the loan, or the servicer; and

(H) Not materially alter collateral for the CRE loan described in paragraph (a)(1)(i) of this section without the consent of the originator or any subsequent holder of the loan, or the servicer.

(4) The loan documentation for the CRE loan prohibits the borrower and each operating affiliate from obtaining a loan secured by a junior lien on collateral for the CRE loan described in paragraph (a)(1)(i) or (a)(1)(ii)(A) of this section, unless:

(i) The sum of the principal amount of such junior lien loan, plus the principal amount of all other loans secured by collateral described in paragraph (a)(1)(i) or (a)(1)(ii)(A) of this section, does not exceed the applicable CLTV ratio in paragraph (a)(5) of this section, 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.

(5) At origination, the applicable loan-to-value ratios for the loan are:

(i) LTV less than or equal to 65 percent and CLTV less than or equal to 70 percent; or

(ii) LTV less than or equal to 60 percent and CLTV less than or equal to 65 percent, if the capitalization rate used in an appraisal that meets the requirements set forth in paragraph (a)(2)(ii) of this section is less than or equal to the sum of:

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

(B) 300 basis points.

(iii) The capitalization rate used in an appraisal under paragraph (a)(2)(ii) of this section must be disclosed to potential investors in the securitization.

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

(i) Based on straight-line amortization of principal and interest over a term that does not exceed 25 years, or 30 years for a qualifying multifamily loan; and

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

(7) Under the terms of the loan agreement:

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

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

(iii) The interest rate on the loan is:

(A) A fixed interest rate; or

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

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

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

(10)(i) The depositor of the asset-backed security certifies that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all qualifying CRE loans that collateralize the asset-backed security and that reduce the sponsor's risk retention requirement under § \_\_\_\_\_.15 meet all of the requirements set forth in paragraphs (a)(1) through (9) of this section and has concluded that its internal supervisory controls are effective;

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

(iii) The sponsor provides, or causes to be provided, a copy of the certification described in paragraph (a)(10)(i) of this section to potential investors a reasonable period of time prior to the sale of asset-backed securities in the issuing entity, and, upon request, to its appropriate Federal banking agency, if any; and

(11) Within two weeks of the closing of the CRE loan by its originator or, if

sooner, prior to the transfer of such CRE loan to the issuing entity, the originator shall 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 described in paragraph (a)(1)(iii) of this section was perfected, other higher priority liens of record on any property described in paragraph (a)(1)(iii) of this section, other than purchase money security interests.

(b) *Cure or buy-back requirement.* If a sponsor has relied on the exception provided in § \_\_\_\_\_.15 with respect to a qualifying CRE loan and it is subsequently determined that the CRE loan did not meet all of the requirements set forth in paragraphs (a)(1) through (a)(9) and (a)(11) of this section, the sponsor shall not lose the benefit of the exception with respect to the CRE loan if the depositor complied with the certification requirement set forth in paragraph (a)(10) of this section, and:

(1) The failure of the loan to meet any of the requirements set forth in paragraphs (a)(1) through (a)(9) and (a)(11) of this section is not material; or

(2) No later than 90 days after the determination that the loan does not meet one or more of the requirements of paragraphs (a)(1) through (a)(9) or (a)(11) of this section, the sponsor:

(i) Effectuates cure, restoring conformity of the loan to the unmet requirements as of the date of 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.

(3) If the sponsor cures or repurchases pursuant to paragraph (b)(2) of this section, the sponsor must promptly notify, or cause to be notified, the holders of the asset-backed securities issued in the securitization transaction of any loan(s) included in such securitization transaction that is required to be cured or repurchased by the sponsor pursuant to paragraph (b)(2) of this section, including the principal amount of such repurchased loan(s) and the cause for such cure or repurchase.

**§ \_\_\_\_\_.18 Underwriting standards for qualifying automobile loans.**

(a) *Underwriting, product and other standards.* (1) Prior to origination of the automobile loan, the originator:

(i) Verified and documented that within 30 days of the date of origination:

(A) The borrower was not currently 30 days or more past due, in whole or in part, on any debt obligation;

(B) 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;

(C) Within the previous 36 months, the borrower has not:

(1) 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

(2) Been the subject of any federal or State judicial judgment for the collection of any unpaid debt;

(D) 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; or

(E) Within the previous 36 months, the borrower has not had any personal property repossessed;

(ii) Determined and documented that the borrower has at least 24 months of credit history; and

(iii) Determined and documented that, upon the origination of the loan, the borrower's DTI ratio is less than or equal to 36 percent.

(A) For the purpose of making the determination under paragraph (a)(1)(iii) of this section, the originator must:

(1) 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

(2) On or after the date of the borrower's written application and prior to origination, obtain a credit report regarding the borrower from a consumer reporting agency that compiles and maintain files on consumers on a nationwide basis (within the meaning of 15 U.S.C. 1681a(p)) and verify that all outstanding debts reported in the borrower's credit report are incorporated into the calculation of the borrower's DTI ratio under paragraph (a)(1)(ii) of this section;

(2) An originator will be deemed to have met the requirements of paragraph (a)(1)(i) of this section if:

(i) The originator, no more than 30 days before the closing of the loan, obtains a credit report regarding the borrower from a consumer reporting agency that compiles and maintains files on consumers on a nationwide basis (within the meaning of 15 U.S.C. 1681a(p));

(ii) Based on the information in such credit report, the borrower meets all of the requirements of paragraph (a)(1)(i) of

this section, and no information in a credit report subsequently obtained by the originator before the closing of the loan contains contrary information; and

(iii) The originator obtains electronic or hard copies of the credit report.

(3) At closing of the automobile loan, the borrower makes 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.

(4) The originator records a first lien securing the loan on the purchased vehicle in accordance with State law.

(5) The terms of the loan agreement 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.

(6) The terms of the loan agreement:

(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) Do 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.

(7) At the closing of the securitization transaction, all payments due on the loan are contractually current; and

(8)(i) The depositor of the asset-backed security certifies that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all qualifying automobile loans that collateralize the asset-backed security and that reduce the sponsor's risk retention requirement under § \_\_\_\_\_.15 meet all of the requirements set forth in paragraphs (a)(1) through (a)(7) of this section and has concluded that its internal supervisory controls are effective;

(ii) The evaluation of the effectiveness of the depositor's internal supervisory controls referenced in paragraph (a)(8)(i) of this section shall be performed, for each issuance of an asset-backed security, as of a date within 60 days of the cut-off date or similar date for establishing the composition of the asset

pool collateralizing such asset-backed security; and

(iii) The sponsor provides, or causes to be provided, a copy of the certification described in paragraph (a)(8)(i) of this section to potential investors a reasonable period of time prior to the sale of asset-backed securities in the issuing entity, and, upon request, to its appropriate Federal banking agency, if any.

(b) *Cure or buy-back requirement.* If a sponsor has relied on the exception provided in § \_\_\_\_\_.15 with respect to a qualifying automobile loan and it is subsequently determined that the loan did not meet all of the requirements set forth in paragraphs (a)(1) through (a)(7) of this section, the sponsor shall not lose the benefit of the exception with respect to the automobile loan if the depositor complied with the certification requirement set forth in paragraph (a)(8) of this section, and:

(1) The failure of the loan to meet any of the requirements set forth in paragraphs (a)(1) through (a)(7) of this section is not material; or

(2) No later than ninety (90) days after the determination that the loan does not meet one or more of the requirements of paragraphs (a)(1) through (a)(7) of this section, the sponsor:

(i) Effectuates cure, establishing conformity of the loan to the unmet requirements as of the date of 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.

(3) If the sponsor cures or repurchases pursuant to paragraph (b)(2) of this section, the sponsor must promptly notify, or cause to be notified, the holders of the asset-backed securities issued in the securitization transaction of any loan(s) included in such securitization transaction that is required to be cured or repurchased by the sponsor pursuant to paragraph (b)(2) of this section, including the principal amount of such loan(s) and the cause for such cure or repurchase.

#### § \_\_\_\_\_.19 General exemptions.

(a) *Definitions.* For purposes of this section, the following definitions shall apply:

*First pay class* means a class of ABS interests for which all interests in the class are entitled to the same priority of payment and that, at the time of 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.

*Inverse floater* means 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.

(b) This part shall not apply to:

(1) *U.S. Government-backed securitizations.* Any securitization transaction that:

(i) 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 United States or an agency of the United States, and servicing assets; or

(ii) Involves the issuance of asset-backed securities that:

(A) Are insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States; and

(B) Are collateralized solely by residential, multifamily, or health care facility mortgage loan assets or interests in such assets, and servicing assets.

(2) *Certain agricultural loan securitizations.* Any securitization transaction that is 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 servicing assets;

(3) *State and municipal securitizations.* Any asset-backed security that is a security issued or guaranteed by any State, or by any political subdivision of a State, or by any public instrumentality of a State that is exempt from the registration requirements of the Securities Act of 1933 by reason of section 3(a)(2) of that Act (15 U.S.C. 77c(a)(2)); and

(4) *Qualified scholarship funding bonds.* Any asset-backed security that meets the definition of a qualified scholarship funding bond, as set forth in section 150(d)(2) of the Internal Revenue Code of 1986 (26 U.S.C. 150(d)(2)).

(5) *Pass-through resecuritizations.* Any securitization transaction that:

(i) Is collateralized solely by servicing assets, and by existing asset-backed securities:

(A) For which credit risk was retained as required under subpart B of this part; or

(B) That was exempted from the credit risk retention requirements of this part pursuant to subpart D of this part;

(ii) Is structured so that it involves the issuance of only a single class of ABS interests; and

(iii) Provides for the pass-through of all principal and interest payments received on the underlying ABS (net of expenses of the issuing entity) to the holders of such class.

(6) *First-pay-class securitizations.* Any securitization transaction that:

(i) Is collateralized solely by servicing assets, and by first-pay classes of asset-backed securities collateralized by first-lien residential mortgages on properties located in any state and servicing assets:

(A) For which credit risk was retained as required under subpart B of this part; or

(B) That was exempted from the credit risk retention requirements of this part pursuant to subpart D of this part;

(ii) Does not provide for any ABS interest issued in the securitization transaction to share in realized principal losses other than pro rata with all other ABS interests based on current unpaid principal balance of the ABS interests at the time the loss is realized;

(iii) Is structured to reallocate prepayment risk;

(iv) Does not reallocate credit risk (other than as a consequence of reallocation of prepayment risk); and

(v) Does not include any inverse floater or similarly structured ABS interest.

(7) *Seasoned loans.* (i) Any securitization transaction that is collateralized solely by servicing assets, and by seasoned loans that meet the following requirements:

(A) The loans have not been modified since origination; and

(B) None of the loans have been delinquent for 30 days or more.

(ii) For purposes of this paragraph, a *seasoned loan* means:

(A) With respect to asset-backed securities backed by residential mortgages, a loan that has been outstanding and performing for the longer of:

(1) A period of five years; or

(2) Until the outstanding principal balance of the loan has been reduced to 25 percent of the original principal balance.

(3) Notwithstanding paragraphs (b)(7)(ii)(A)(1) and (b)(7)(ii)(A)(2) of this section, any residential mortgage loan that has been outstanding and performing for a period of at least seven years shall be deemed a seasoned loan.

(B) With respect to all other classes of asset-backed securities, a loan that has been outstanding and performing for the longer of:

(1) A period of at least two years; or

(2) Until the outstanding principal balance of the loan has been reduced to

33 percent of the original principal balance.

(8) *Certain public utility securitizations.* (i) Any securitization transaction where the asset-backed securities issued in the transaction are secured by the intangible property right to collect charges for the recovery of specified costs and such other assets, if any, of an issuing 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.

(ii) For purposes of this paragraph:

(A) *Specified cost* means any cost identified by a State legislature as appropriate for recovery through securitization pursuant to specified cost recovery legislation; and

(B) *Specified cost recovery legislation* means legislation enacted by a State that:

(1) Authorizes the investor owned 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;

(2) 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 non-bypassable 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

(3) 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.

(c) *Exemption for securitizations of assets issued, insured or guaranteed by the United States.* This part shall not apply to any securitization transaction if the asset-backed securities issued in the transaction are:

(1) Collateralized solely by obligations issued by the United States or an agency of the United States and servicing assets;

(2) Collateralized solely by assets that are fully insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United

States (other than those referred to in paragraph (b)(1)(i) of this section) and servicing assets; or

(3) Fully guaranteed as to the timely payment of principal and interest by the United States or any agency of the United States;

(d) *Federal Deposit Insurance Corporation securitizations.* This part shall not apply to any securitization transaction that is sponsored by the Federal Deposit Insurance Corporation acting as conservator or receiver under any provision of the Federal Deposit Insurance Act or of Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

(e) *Reduced requirement for certain student loan securitizations.* The 5 percent risk retention requirement set forth in § \_\_\_\_ .4 shall be modified as follows:

(1) With respect to a securitization transaction that is collateralized solely by student loans made under the Federal Family Education Loan Program ("FFELP loans") that are guaranteed as to 100 percent of defaulted principal and accrued interest, and servicing assets, the risk retention requirement shall be 0 percent;

(2) With respect to a securitization transaction that is collateralized solely by FFELP loans that are guaranteed as to at least 98 percent of defaulted principal and accrued interest, and servicing assets, the risk retention requirement shall be 2 percent; and

(3) With respect to any other securitization transaction that is collateralized solely by FFELP loans, and servicing assets, the risk retention requirement shall be 3 percent.

(f) *Rule of construction.* Securitization transactions involving the issuance of asset-backed securities that are either issued, insured, or guaranteed by, or are collateralized by obligations issued by, or loans that are issued, insured, or guaranteed by, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or a Federal home loan bank shall not on that basis qualify for exemption under this section.

#### § \_\_\_\_ .20 Safe harbor for certain foreign-related transactions.

(a) *Definitions.* For purposes of this section, the following definition shall apply:

*U.S. person* means:

(1) Any of the following:

(i) Any natural person resident in the United States;

(ii) Any partnership, corporation, limited liability company, or other organization or entity organized or incorporated under the laws of any State or of the United States;

(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 United States;

(vi) Any non-discretionary 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 United States; 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 Act; and

(2) "U.S. person(s)" 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 United States;

(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 United States and customary practices and documentation of such country;

(v) Any agency or branch of a U.S. person located outside the United States if:

(A) The agency or branch operates for valid business reasons; and

(B) The agency or branch is engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation, respectively, in the jurisdiction where located;

(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.

(b) *In general.* This part shall not apply to a securitization transaction if all the following conditions are met:

(1) The securitization transaction is not required to be and is not registered under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*);

(2) No more than 10 percent of the dollar value (or equivalent amount in the currency in which the ABS is issued, as applicable) of all classes of ABS interests in the securitization transaction are sold or transferred to U.S. persons or for the account or benefit of U.S. persons;

(3) Neither the sponsor of the securitization transaction nor the issuing entity is:

(i) Chartered, incorporated, or organized under the laws of the United States or any State;

(ii) An unincorporated branch or office (wherever located) of an entity chartered, incorporated, or organized under the laws of the United States or any State; or

(iii) An unincorporated branch or office located in the United States or any State of an entity that is chartered, incorporated, or organized under the laws of a jurisdiction other than the United States or any State; and

(4) If the sponsor or issuing entity is chartered, incorporated, or organized under the laws of a jurisdiction other than the United States or any State, no more than 25 percent (as determined based on unpaid principal balance) of the assets that collateralize the ABS interests sold in the securitization transaction were acquired by the sponsor or issuing entity, 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 United States or any State; or

(ii) An unincorporated branch or office of the sponsor or issuing entity that is located in the United States or any State.

(b) *Evasions prohibited.* In view of the objective of these rules and the policies underlying Section 15G of the Exchange Act, the safe harbor described in paragraph (a) of this section is not available with respect to any transaction or series of transactions that, although in technical compliance with such paragraph (a) of this section, is part of

a plan or scheme to evade the requirements of section 15G and this Regulation. In such cases, compliance with section 15G and this part is required.

#### § 21 Additional exemptions.

(a) *Securitization transactions.* The federal agencies with rulewriting authority under section 15G(b) of the Exchange Act (15 U.S.C. 78o–11(b)) with respect to the type of assets involved may jointly provide a total or partial exemption of any securitization transaction as such agencies determine may be appropriate in the public interest and for the protection of investors.

(b) *Exceptions, exemptions, and adjustments.* The Federal banking agencies and the Commission, in consultation with the Federal Housing Finance Agency and the Department of Housing and Urban Development, may jointly adopt or issue exemptions, exceptions or adjustments to the requirements of this part, including exemptions, exceptions or adjustments for classes of institutions or assets in accordance with section 15G(e) of the Exchange Act (15 U.S.C. 78o–11(e)).

#### End of Common Rule

##### List of Subjects

###### 12 CFR Part 43

Automobile loans, Banks and banking, Commercial loans, Commercial real estate, Credit risk, Mortgages, National banks, Reporting and recordkeeping requirements, Risk retention, Securitization.

###### 12 CFR Part 244

Auto loans, Banks and banking, Bank holding companies, Commercial loans, Commercial real estate, Credit risk, Edge and agreement corporations, Foreign banking organizations, Mortgages, Nonbank financial companies, Reporting and recordkeeping requirements, Risk retention, Savings and loan holding companies, Securitization, State member banks.

###### 12 CFR Part 373

Automobile loans, Banks and banking, Commercial loans, Commercial real estate, Credit risk, Mortgages, Reporting and recordkeeping requirements, Risk retention, Savings associations, Securitization.

###### 12 CFR Part 1234

Government sponsored enterprises, Mortgages, Securities.

###### 17 CFR Part 246

Reporting and recordkeeping requirements, Securities.

###### 24 CFR Part 267

Mortgages.

#### Adoption of the Common Rule Text

The proposed adoption of the common rules by the agencies, as modified by agency-specific text, is set forth below:

#### DEPARTMENT OF THE TREASURY

##### Office of the Comptroller of the Currency

##### 12 CFR Chapter I

##### Authority and Issuance

For the reasons stated in the common preamble and under the authority of 12 U.S.C. 93a, 1464, 5412(b)(2)(B), and 15 U.S.C. 78o–11, the Office of the Comptroller of the Currency proposes to amend chapter I of title 12, Code of Federal Regulations as follows:

#### PART 43—CREDIT RISK RETENTION

■ 1. The authority for part 43 is added to read as follows:

**Authority:** 12 U.S.C. 1 *et seq.*, 93a, 161, 1464, 1818, 5412(b)(2)(B), and 15 U.S.C. 78o–11.

■ 2. Part 43 is added as set forth at the end of the Common Preamble.

■ 3. Section 43.1 is added to read as follows:

##### § 43.1 Authority, purpose, scope, and reservation of authority.

(a) *Authority.* This part is issued under the authority of 12 U.S.C. 1 *et seq.*, 93a, 161, 1464, 1818, 5412(b)(2)(B), and 15 U.S.C. 78o–11.

(b) *Purpose.* (1) This part requires securitizers to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party. This part specifies the permissible types, forms, and amounts of credit risk retention, and it establishes certain exemptions for securitizations collateralized by assets that meet specified underwriting standards.

(2) Nothing in this part shall be read to limit the authority of the OCC to take supervisory or enforcement action, including action to address unsafe or unsound practices or conditions, or violations of law.

(c) *Scope.* This part applies to any securitizer that is a national bank, a Federal savings association, a Federal branch or agency of a foreign bank, or a subsidiary thereof.

(d) *Effective dates.* This part shall become effective:

(1) With respect to any securitization transaction collateralized by residential

mortgages, one year after the date on which the final rules under section 15G(b) of the Exchange Act (15 U.S.C. 780–11(b)) are published in the **Federal Register**; and

(2) With respect to any other securitization transaction, two years after the date on which final rules under section 15G(b) of the Exchange Act (15 U.S.C. 780–11(b)) are published in the **Federal Register**.

## Board of Governors of the Federal Reserve System

### 12 CFR Chapter II

#### Authority and Issuance

For the reasons set forth in the Supplementary Information, the Board of Governors of the Federal Reserve System proposes to add the text of the common rule as set forth at the end of the Supplementary Information as part 244 to chapter II of title 12, Code of Federal Regulations, modified as follows:

#### PART 244—CREDIT RISK RETENTION (REGULATION RR)

■ 4. The authority citation for part 244 is added to read as follows:

**Authority:** 12 U.S.C. 221 *et seq.*, 1461 *et seq.*, 1818, 1841 *et seq.*, 3103 *et seq.*, and 15 U.S.C. 780–11.

■ 4a. The part heading for part 244 is revised as set forth above.

■ 5. Section 244.1 is added to read as follows:

##### § 244.1 Authority, purpose, and scope.

(a) *Authority*—(1) *In general*. This part (Regulation RR) is issued by the Board of Governors of the Federal Reserve System under section 15G of the Securities Exchange Act of 1934, as amended (Exchange Act) (15 U.S.C. 780–11), as well as under the Federal Reserve Act, as amended (12 U.S.C. 221 *et seq.*); section 8 of the Federal Deposit Insurance Act (FDI Act), as amended (12 U.S.C. 1818); the Bank Holding Company Act of 1956, as amended (BHC Act) (12 U.S.C. 1841 *et seq.*); the Home Owners' Loan Act of 1933 (HOLA) (12 U.S.C. 1461 *et seq.*); section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) (12 U.S.C. 5365); and the International Banking Act of 1978, as amended (12 U.S.C. 3101 *et seq.*).

(2) Nothing in this part shall be read to limit the authority of the Board to take action under provisions of law other than 15 U.S.C. 780–11, including action to address unsafe or unsound practices or conditions, or violations of law or regulation, under section 8 of the FDI Act.

(b) *Purpose*. This part requires any securitizer to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party in a transaction within the scope of section 15G of the Exchange Act. This part specifies the permissible types, forms, and amounts of credit risk retention, and establishes certain exemptions for securitizations collateralized by assets that meet specified underwriting standards or that otherwise qualify for an exemption.

(c) *Scope*. (1) This part applies to any securitizer that is:

(i) A state member bank (as defined in 12 CFR 208.2(g)); or

(ii) Any subsidiary of a state member bank.

(2) Section 15G of the Exchange Act and the rules issued thereunder apply to any securitizer that is:

(i) A bank holding company (as defined in 12 U.S.C. 1842);

(ii) A foreign banking organization (as defined in 12 CFR 211.21(o));

(iii) An Edge or agreement corporation (as defined in 12 CFR 211.1(c)(2) and (3));

(iv) A nonbank financial company that the Financial Stability Oversight Council has determined under section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) (12 U.S.C. 5323) shall be supervised by the Board and for which such determination is still in effect; or

(v) A savings and loan holding company (as defined in 12 U.S.C. 1467a); and

(vi) Any subsidiary of the foregoing. The Federal Reserve will enforce section 15G of the Exchange Act and the rules issued thereunder under section 8 of the FDI Act against any of the foregoing entities.

#### Federal Deposit Insurance Corporation 12 CFR Chapter III

##### Authority and Issuance

For the reasons set forth in the **SUPPLEMENTARY INFORMATION**, the Federal Deposit Insurance Corporation proposes to add the text of the common rule as set forth at the end of the **SUPPLEMENTARY INFORMATION** as part 373 to chapter III of title 12, Code of Federal Regulations, modified as follows:

#### PART 373—CREDIT RISK RETENTION

■ 6. The authority citation for part 373 is added to read as follows:

**Authority:** 12 U.S.C. 1801 *et seq.* and 3103 *et seq.*, and 15 U.S.C. 780–11.

■ 7. Section 373.1 is added to read as follows:

##### § 373.1 Purpose and scope.

(a) *Authority*—(1) *In general*. This part is issued by the Federal Deposit Insurance Corporation (FDIC) under section 15G of the Securities Exchange Act of 1934, as amended (Exchange Act) (15 U.S.C. 780–11), as well as the Federal Deposit Insurance Act (12 U.S.C. 1801 *et seq.*) and the International Banking Act of 1978, as amended (12 U.S.C. 3101 *et seq.*).

(2) Nothing in this part shall be read to limit the authority of the FDIC to take action under provisions of law other than 15 U.S.C. 780–11, including to address unsafe or unsound practices or conditions, or violations of law or regulation under section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818).

(b) *Purpose*. (1) This part requires securitizers to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party in a transaction within the scope of section 15G of the Exchange Act. This part specifies the permissible types, forms, and amounts of credit risk retention, and it establishes certain exemptions for securitizations collateralized by assets that meet specified underwriting standards or that otherwise qualify for an exemption.

(c) *Scope*. This part applies to any securitizer that is:

(1) A state nonmember bank (as defined in 12 U.S.C. 1813(e)(2));

(2) An insured federal or state branch of a foreign bank (as defined in 12 CFR 347.202);

(3) A state savings association (as defined in 12 U.S.C. 1813(b)(3)); or

(4) Any subsidiary of an entity described in paragraphs (1), (2), or (3) of this section.

#### Federal Housing Finance Agency

For the reasons stated in the **SUPPLEMENTARY INFORMATION**, and under the authority of 12 U.S.C. 4526, the Federal Housing Finance Agency proposes to add the text of the common rule as set forth at the end of the Supplementary Information as part 1234 of subchapter B of chapter XII of title 12 of the Code of Federal Regulations, modified as follows:

#### Chapter XII—Federal Housing Finance Agency

##### Subchapter B—Entity Regulations

#### PART 1234—CREDIT RISK RETENTION

■ 8. The authority citation for part 1234 is added to read as follows:

**Authority:** 12 U.S.C. 4511(b), 4526, 4617; 15 U.S.C. 78o–11(b)(2).

■ 9. Section 1234.1 is added to read as follows:

**§ 1234.1 Purpose, scope and reservation of authority.**

(a) *Purpose.* This part requires securitizers to retain an economic interest in a portion of the credit risk for any residential mortgage asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party in a transaction within the scope of section 15G of the Exchange Act. This part specifies the permissible types, forms, and amounts of credit risk retention, and it establishes certain exemptions for securitizations collateralized by assets that meet specified underwriting standards or that otherwise qualify for an exemption.

(b) *Scope.* Effective [INSERT DATE ONE YEAR AFTER DATE OF PUBLICATION IN THE **Federal Register** AS A FINAL RULE], this part will apply to any securitizer that is an entity regulated by the Federal Housing Finance Agency.

(c) *Reservation of authority.* Nothing in this part shall be read to limit the authority of the Director of the Federal Housing Finance Agency to take supervisory or enforcement action, including action to address unsafe or unsound practices or conditions, or violations of law.

■ 10. Amend § 1234.14 as follows:

■ a. Revise the heading to read as set forth below.

■ b. In the introductory paragraph, remove the words “§§ 1234.15 through 1234.18” and add in their place the words “§§ 1234.15 and 1234.17”.

■ c. Remove the definitions of “Automobile loan”, “Commercial loan”, “Debt-to-income (DTI) ratio”, “Earnings before interest, taxes, depreciation, and amortization (EBITDA)”, “Lease financing”, “Leverage Ratio”, “Machinery and equipment (M&E) collateral”, “Model year”, “Payment-in-kind”, “Purchase price”, “Salvage title”, “Total debt”, “Total liabilities ratio”, and “Trade-in allowance”.

■ d. Revise the definition of “Debt service coverage (DSC) ratio” to read as follows:

**§ 1234.14 Definitions applicable to qualifying commercial real estate loans.**

\* \* \* \* \*

*Debt service coverage (DSC) ratio* means the ratio of:

(1) The annual NOI less the annual replacement reserve of the CRE property at the time of origination of the CRE loans; to

(2) The sum of the borrower’s annual payments for principal and interest on any debt obligation.

\* \* \* \* \*

■ 11. Revise § 1234.15 to read as follows:

**§ 1234.15 Qualifying commercial real estate loans.**

(a) *General exception.* Commercial real estate loans that are securitized through a securitization transaction shall be subject to a 0 percent risk retention requirement under subpart B, provided that the following conditions are met:

(1) The CRE assets meet the underwriting standards set forth in § 1234.16;

(2) The securitization transaction is collateralized solely by CRE loans and by servicing assets;

(3) The securitization transaction does not permit reinvestment periods; and

(4) The sponsor provides, or causes to be provided, to potential investors a reasonable period of time prior to the sale of asset-backed securities of the issuing entity, and, upon request, to the Commission, and to the FHFA, in written form under the caption “Credit Risk Retention”:

(i) A description of the manner in which the sponsor determined the aggregate risk retention requirement for the securitization transaction after including qualifying CRE loans with 0 percent risk retention; and

(ii) Descriptions of the qualifying CRE loans and descriptions of the CRE loans that are not qualifying CRE loans, and the material differences between the group of qualifying CRE loans and CRE loans 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.

(b) *Risk retention requirement.* For any securitization transaction described in paragraph (a) of this section, the amount of risk retention required under § 1234.3(b)(1) is reduced by the same amount as the ratio of the unpaid principal balance of the qualifying CRE loans to the total unpaid principal balance of CRE loans that are included in the pool of assets collateralizing the asset-backed securities issued pursuant to the securitization transaction (the qualifying asset ratio); provided that:

(1) The qualifying asset ratio is measured as of the cut-off date or similar date for establishing the composition of the pool assets collateralizing the asset-backed securities issued pursuant to the securitization transaction; and

(2) The qualifying asset ratio does not exceed 50 percent.

(c) *Exception for securitizations of qualifying CRE only.* Notwithstanding other provisions of this section, the risk retention requirements of subpart B of this part shall not apply to securitization transactions where the transaction is collateralized solely by servicing assets and qualifying CRE loans.

**§§ 1234.16 and 1234.18 [Removed and Reserved]**

■ 12. Remove and reserve §§ 1234.16 and 1234.18.

**Securities and Exchange Commission**

For the reasons stated in the Supplementary Information, the Securities and Exchange Commission proposes the amendments under the authority set forth in Sections 7, 10, 19(a), and 28 of the Securities Act and Sections 3, 13, 15, 15G, 23 and 36 of the Exchange Act.

For the reasons set out above, title 17, chapter II of the Code of Federal Regulations is proposed to be amended as follows:

**PART 246—CREDIT RISK RETENTION**

■ 13. The authority citation for part 246 is added to read as follows:

**Authority:** 15 U.S.C. 77g, 77j, 77s, 77z–3, 78c, 78m, 78o, 78o–11, 78w, 78mm

■ 14. Part 246 is added as set forth at the end of the Common Preamble.

■ 15. Section 246.1 is added to read as follows:

**§ 246.1 Purpose, scope, and authority.**

(a) *Authority and purpose.* This part (Regulation RR) is issued by the Securities and Exchange Commission (“Commission”) jointly with the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and, in the case of the securitization of any residential mortgage asset, together with the Secretary of Housing and Urban Development and the Federal Housing Finance Agency, pursuant to Section 15G of the Securities Exchange Act of 1934 (15 U.S.C. 78o–11). The Commission also is issuing this part pursuant to its authority under Sections 7, 10, 19(a), and 28 of the Securities Act and Sections 3, 13, 15, 23, and 36 of the Exchange Act. This part requires securitizers to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party. This part specifies the

permissible types, forms, and amounts of credit risk retention, and establishes certain exemptions for securitizations collateralized by assets that meet specified underwriting standards or otherwise qualify for an exemption.

(b) The authority of the Commission under this part shall be in addition to the authority of the Commission to otherwise enforce the federal securities laws, including, without limitation, the antifraud provisions of the securities laws.

### Department of Housing and Urban Development

#### Authority and Issuance

For the reasons stated in the **SUPPLEMENTARY INFORMATION**, HUD proposes to add the text of the common rule as set forth at the end of the **SUPPLEMENTARY INFORMATION** to 24 CFR chapter II, subchapter B, as a new part 267 to read as follows:

#### **PART 267—CREDIT RISK RETENTION**

■ 16. The authority citation for part 267 is added to read as follows:

**Authority:** 15 U.S.C. 78–o–11; 42 U.S.C. 3535(d).

■ 17. Section 267.1 is added to read as follows:

#### **§ 267.1 Credit risk retention exceptions and exemptions for HUD programs.**

The credit risk retention regulations codified at 12 CFR part 43 (Office of the Comptroller of the Currency); 12 CFR part 244 (Federal Reserve System); 12 CFR part 373 (Federal Deposit Insurance Corporation); 17 CFR part 246 (Securities and Exchange Commission); and 12 CFR part 1234 (Federal Housing Finance Agency) include exceptions and exemptions in subpart D of each of these codified regulations for certain transactions involving programs and entities under the jurisdiction of the Department of Housing and Urban Development.

Dated: August 28, 2013.

**Thomas J. Curry,**  
*Comptroller of the Currency.*

By order of the Board of Governors of the Federal Reserve System, August 27, 2013.

**Robert deV. Frierson,**  
*Secretary of the Board.*

Dated at Washington, DC, this 28 of August 2013.

By order of the Board of Directors.  
Federal Deposit Insurance Corporation.

**Robert E. Feldman,**  
*Executive Secretary.*

Dated: August 28, 2013.

By the Securities and Exchange Commission.

**Elizabeth M. Murphy**  
*Secretary.*

Dated: August 28, 2013.

**Edward J. DeMarco,**  
*Acting Director, Federal Housing Finance Agency.*

Dated: August 26, 2013.

By the Department of Housing and Urban Development.

**Shaun Donovan,**  
*Secretary.*

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