



U.S. Retained Credit Risk Rules Take Shape

On March 29, 2011, the Federal Reserve Board and the FDIC separately approved a joint notice of proposed rulemaking (the “NPR”) implementing the credit risk retention requirements of section 941 of the Dodd-Frank Act, which added a new section 15G to the Securities Act of 1933, as amended (the “Securities Act”). The NPR also was subsequently approved by the Securities and Exchange Commission (“SEC”), the Department of Housing and Urban Development, the Federal Housing Finance Agency, and the Office of the Comptroller of the Currency. The NPR was jointly issued on March 31, 2011, for a 60-day comment period following publication in the Federal Register, which will end on June 10, 2011.

As required by section 941, the NPR would generally require securitizers to retain not less than 5% of the credit risk of the assets collateralizing any asset-backed securities (“ABS”) issuance.

Definition of “Asset-Backed Securities”

The term “asset-backed securities” is used in the NPR as it is defined in section 3(a)(77) of the Securities Exchange Act of 1934, as amended, rather than in the narrower definition under Regulation AB. Therefore, section 15G will be applicable to both registered and unregistered ABS issuances. However, since the definition is limited to “fixed-income or other security collateralized by any type of self-liquidating financial asset that allows the holder of the security to receive payments that depend primarily on cash flow from the asset,” synthetic securitizations are not covered by the NPR.

Types of Risk Retention Permitted

General Risk Retention Options

The 5% risk may be retained in a variety of ways to adapt to the various types of assets securitized and the different structures developed and accepted in the market. A sponsor may retain its risk in any one of the following ways:

- a 5% “vertical” slice of the ABS interests;
- a 5% “horizontal” first-loss position;
- an “L-shaped interest” whereby the sponsor holds at least half of the 5% retained interest in the form of a vertical slice and at least 2.564% of the par value of all ABS interests in the issuing entity in the form of a horizontal first-loss position (excluding the assets required to be held as part of the vertical slice);

- an amount equal to the eligible horizontal residual interest funded into a cash reserve fund account maintained by a trustee so that the sponsor experiences losses on the underlying assets as it would under an eligible horizontal residual interest; or
- a representative sample, whereby the sponsor retains a 5% representative sample of the assets to be securitized.

It is not clear from the NPR if the options above are the only risk retention options available, or if they can be further combined; however, the NPR requests comment on whether the “menu option” approach is appropriate and whether other forms of risk retention should be permitted.

Transaction-Specific Risk Retention

The NPR also provides for certain transaction-specific risk retention options for revolving asset master trusts, asset-backed commercial paper conduits (“ABCP conduits”), commercial mortgage-backed securities (“CMBS”) issuances, and Fannie Mae and Freddie Mac ABS.

Revolving Master Trusts

Recognizing that a sponsor of a securitization involving a revolving master trust (such as credit card and dealer floorplan securitizations) typically retains a direct, shared interest with all of the investors in the performance of the underlying assets or receivables, known as a “seller’s interest,” the NPR permits a sponsor of an ABS issuance collateralized by assets held in a revolving master trust to retain a seller’s interest of not less than 5% of the unpaid principal balance of all assets held by the master trust.

ABCP Conduits

To maintain current ABCP market practice, sponsors of certain eligible single-seller or multi-seller ABCP conduits may meet the risk retention requirement if the receivables’ originator-seller retains a horizontal residual interest equal to at least 5% of the par value of all interests issued by an intermediate special-purpose vehicle (“SPV”). In order for an ABCP conduit to rely on this transaction-specific arrangement, it must be responsible for and meet the following conditions:

- compliance with the risk retention requirement;
- approval of the originator-seller(s);
- establishment of criteria governing eligible assets;
- approval of all interests in the intermediate SPV to be purchased by the ABCP conduit; and
- administration of the operation of the ABCP conduit in compliance with the NPR.

CMBS

If certain conditions are satisfied, the NPR permits a CMBS sponsor to allocate its risk retention requirements to a third-party purchaser who acquires an eligible horizontal residual interest in the issuing entity in the same form, amount, and manner as would be required of the sponsor.

The risk retention requirement would be met if the third-party purchaser negotiates for the purchase of a first-loss position; holds adequate financial resources to back losses; conducts due diligence on each asset in the asset pool before the issuance of the CMBS; and meets the same standards for risk retention as the securitizer.

In addition, the NPR requires the CMBS transaction documents to provide for the appointment of an independent operating advisor with certain powers and responsibilities if the third-party purchaser is the servicer or an affiliate of the servicer having control rights related to such servicing. The operating advisor is required to act in the best interest and for the benefit of investors as a collective whole; must be consulted on all major decisions in connection with servicing the securitized assets; must periodically review the actions of the servicer; and may recommend the appointment of a new servicer for the transaction.

Government-Sponsored Enterprises

The NPR also permits Fannie Mae and Freddie Mac, or any limited-life regulated entity that succeeds to the charter of Fannie Mae or Freddie Mac, to satisfy the risk retention requirement through their guarantees as long as they continue to operate under the conservatorship or receivership of the FHFA and with direct government support through the Treasury Department.

Exemptions, Reductions, and Safe Harbors

The NPR completely exempts certain types of securitizations from the risk retention, and permits the Agencies to establish reduced risk retention requirements for securitizations of assets that meet certain eligibility criteria. Exemptions will be available for government-guaranteed securitizations and assets and qualifying “pass-through” resecuritizations. Also exempt are auto loans, commercial loans, and commercial real estate loans that meet specified underwriting standards, as well as qualified residential mortgage loans, or “QRMs,” that meet certain underwriting standards, avoid certain risky payment features, and are serviced according to specified servicing provisions set forth in the mortgage loan documents.

Government Guarantees

The proposed rules provide the following exemptions from risk retention for government securitizations:

- ABS collateralized by obligations issued by, or by assets insured or guaranteed by, the U.S. government;
- ABS issued by any state of the United States or any subdivision thereof that is exempt from registration under section 3(a)(2) of the Securities Act;
- ABS insured or guaranteed by the U.S. government;
- ABS collateralized by assets made, insured, guaranteed, or purchased by institutions supervised by the Farm Credit Administration; or
- ABS that constitute qualified scholarship funding bonds.

Resecuritizations

The NPR also provides a limited exemption for risk retention for single-tranche resecuritizations that do not alter the payment terms and credit risk of the underlying ABS interests.

Qualified Residential Mortgages

To qualify as a QRM, a mortgage loan must meet the following standards:

- maximum front-end and back-end borrower debt-to-income ratios of 28% and 36%, respectively;
- a maximum LTV ratio of 80% in the case of a purchase transaction (with a 75% combined LTV permitted for refinance transactions, reduced to 70% for cash-out refis);

- a 20% down payment requirement in the case of a purchase transaction;
- no risky payment features, such as negative amortization, balloon payments, or the ability of the lender or servicer to raise interest rates excessively; and
- borrower credit history restrictions, including no 60-day delinquencies on any debt obligation within the previous 24 months.

Certain servicing procedures and policies, including procedures for loss mitigation, and procedures to address subordinate liens on the same property securing other loans held by the same creditor, must also be implemented and set forth in the mortgage loan documents themselves.

In addition, the NPR sets forth certain “derogatory factors” relating to a borrower that would, if present, automatically disqualify a mortgage loan from being a QRM. Such factors include whether a borrower has (i) had any delinquency or default on debt repayment, (ii) filed for bankruptcy, (iii) been party to a foreclosure proceeding, or (iv) had any assets or property repossessed. The originator must confirm this borrower information by obtaining credit reports from at least two credit agencies.

The depositor of the ABS must certify that it has evaluated the effectiveness of its internal controls with respect to its process for determining that the mortgage loans that collateralize the ABS are QRMs and that such controls are effective. In the event that it is determined after the closing date of the securitization that some of the assets are not QRMs due to inadvertent error, the exemption from the risk retention requirements will still be available provided that certain conditions are met.

Qualifying Commercial Real Estate Loans, Other Commercial Loans, and Auto Loans

The NPR also provides an exemption from the risk retention requirements for commercial real estate loans, other commercial loans, and auto loans, and any other asset class that the Agencies deem appropriate that were underwritten using conservative guidelines. Commercial real estate loans and other commercial loans must satisfy minimum debt service coverage ratios, or maximum LTV or leverage ratios, as applicable. The financial ability of the borrower to repay the loan must be demonstrated by proof of income generated by the real estate or other business revenue. Loan documents must contain covenants relating to maintenance of the collateral and prohibiting the borrower from over-leveraging the collateral or compromising the security interest of the lender. In some cases, the borrower may have to maintain insurance in an amount no less than the lender’s interest in the collateral with the lender as the named beneficiary of such insurance.

Auto loan borrowers must have debt to income ratios equal to or less than 36%, and a credit history within the past 30 days clear of delinquencies of 30 days or more, and no bankruptcy, foreclosure, or similar proceeding in the previous 36 months. The borrower also must meet certain down payment requirements and may not be permitted to defer principal or interest under the loan documents.

Foreign Transaction Safe Harbor

Finally, the proposed rules include a safe harbor with respect to certain predominantly foreign securitizations based on the limited nature of the securitizations’ connections with the U.S. and U.S. investors. The safe harbor is intended to exclude from the risk retention requirements securitizations in which the effects on U.S. interests or persons are sufficiently remote so as not to significantly impact underwriting standards and risk management practices in the U.S. or in the interest of U.S. investors.

To qualify for the foreign transaction safe harbor, the securitization must meet the following conditions:

- the transaction is not required to be and is not registered under the Securities Act of 1933, as amended;

- no more than 10% of the dollar value by proceeds (or equivalent if sold in a foreign currency) of all classes of ABS interests sold in the transaction are sold to U.S. persons or for the account or benefit of U.S. persons;
- neither the sponsor of the transaction nor the issuing entity is (i) chartered, incorporated, or organized under the laws of the U.S., or a U.S. state or territory, or (ii) the unincorporated branch or office located in the U.S. of an entity not chartered, incorporated, or organized under the laws of the U.S., or a U.S. state or territory; and
- no more than 25% of the assets collateralizing the ABS sold in the transaction were acquired by the sponsor, directly or indirectly, from a consolidated affiliate of the sponsor or issuing entity that is (i) chartered, incorporated, or organized under the laws of the U.S., or a U.S. state or territory, or (ii) the unincorporated branch or office located in the U.S. of an entity not chartered, incorporated, or organized under the laws of the U.S., or a U.S. state or territory.

The foreign transaction safe harbor would not be available for any transaction or series of transactions that, although in technical compliance with the conditions of the safe harbor, is part of a plan or scheme to evade the requirements of section 15G of the Securities Act or the NPR.

Hedging or Transferring Risk Retention; Adjustments for Excess Spread

Prohibition on Hedging or Transferring of Risk

The NPR prohibits a sponsor from transferring any interest or assets that it is required to retain under section 15G of the Securities Act to any person other than a consolidated affiliate and prohibits a sponsor or any consolidated affiliate from hedging the credit risk the sponsor is required to retain under section 15G. The prohibition on hedging is limited to the credit risk the sponsor is required to retain; therefore, hedge positions that are not materially related to the credit risk of a particular ABS interest or exposure required to be retained, such as general interest rate risk, currency exchange rate risk, and overall market movement risk (home prices, for example) are permitted.

When determining materiality, the sponsor should consider if the hedge is related to risks associated with a specific ABS issuance, or the overall value of a particular broad category of ABS or the market generally. Hedges based on indices generally are permitted also, provided that (i) any class of ABS interests in the issuing entity that were issued in connection with the transactions and that are included in the index represent no more than 10% of the dollar-weighted average of all instruments included in the index, and (ii) all classes of ABS interests in all issuing entities that were issued in connection with any transactions in which the sponsor was required to retain an interest pursuant to the NPR, and that are included in the index, represent, in the aggregate, no more than 20% of the dollar-weighted average of all instruments included in the index.

The NPR also would prohibit a sponsor and any consolidated affiliate from pledging as collateral for any obligation any interest or asset that the sponsor is required to retain, unless the obligation is with full recourse to the sponsor or consolidated affiliate. An originator, originator-seller, or a third-party purchaser who retains credit risk in accordance with the NPR must comply with the hedging prohibition to the same extent as the sponsor.

Adjustment for Excess Spread/Premium Capture Reserve Account

Although it is not a hedging or transfer of risk, before the financial crisis sponsors often would sell premium or interest-only tranches in securitizations at the inception of a transaction in order to monetize the “excess spread” that was expected to be generated by the securitized assets over time. Since this occurs at the inception of the securitization, the sponsor can earn profits before the performance of the securitized assets can be observed and

unexpected losses realized, and, in the view of the federal regulators, it enables sponsors to reduce the impact of any economic interest securitizers may have retained in the outcome of the transaction and in the credit quality of the assets securitized. The NPR addresses “excess spread” by requiring sponsors to adjust the required amount of risk retention held to account for any excess spread that is monetized at the closing of a securitization in order to prevent sponsors from effectively reducing the economic exposure they are required to retain. To achieve this adjustment, any sponsor who sells premium or interest-only tranches in securitizations must deposit any “excess spread” into a “premium capture cash reserve account.” The amount in the premium capture cash reserve account would be used to cover losses on the underlying assets before such losses were allocated to any other interest or account.

Industry and Public Reaction

The NPR seeks input on more than 170 questions raised by the Agencies. Analysts speculate that there will be plenty of time for industry participants to voice concerns publicly and privately and that there will be a number of changes worked in to the final rule. The most controversial point raised by industry participants and consumer advocates is the narrow definition of “QRM,” and the impact that the 20% down payment requirement will have on the housing industry and the availability of financing for middle-income borrowers. Other influential decision makers, including Representative Garrett (R-NJ), Chairman of the Committee on Financial Services’ Subcommittee on Capital Markets and Government-Sponsored Enterprises, have spoken out against the exemption from the risk retention requirements for Fannie Mae and Freddie Mac ABS. Immediately following the approval of the NPR by the FDIC and the Federal Reserve Board, Representative Garrett even introduced a draft bill to the House of Representatives that would require mortgage loans held and securitized by Fannie Mae and Freddie Mac to be treated similarly to mortgage loans held and securitized by other industry participants with respect to credit risk retention requirements. The bill has support from both Republican and Democratic members of the House. Currently, Fannie Mae and Freddie Mac are responsible for more than 90% of mortgage origination in the U.S. Those against their exemption from the risk retention rules argue that the mortgage finance market will remain in its current state and that the unlevel playing field will delay the government’s wind-down of Fannie Mae and Freddie Mac by discouraging private investors from entering, or coming back to, the mortgage finance market. Many mortgage originators and sponsors also are concerned over the “premium capture cash reserve account” requirement which, according to some, will severely impact the profitability of securitizations and therefore the incentive of market participants to provide housing finance, especially with respect to premium loan securitizations, since the sponsor will not be able to monetize the excess spread at issuance. They also observe that, by discouraging excess spread, the requirement likely will lead lenders to increase the amount of upfront fees they charge, making it more expensive for borrowers to close a home loan.

Longer-term Perspective

The issuance of the NPR brings the mortgage market one step closer to establishing the regulatory framework for the post-financial crisis housing, consumer and commercial finance markets in the U.S. It is evident, though, that substantial unresolved issues still lurk in the NPR. Other major unresolved issues, including the future of Fannie Mae and Freddie Mac and the disclosure rules applicable to securities to be addressed by proposed amendments to the SEC’s Regulation AB, continue to impede the resumption of normal mortgage and ABS markets. It is likely that many potential market participants will continue to “sit out” the market until these major pieces of the regulatory puzzle are put into place.

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