Client Alert

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CURRENT ISSUES RELEVANT TO OUR CLIENTS APRIL 5, 2011

Dodd-Frank: Joint Rules on Risk Retention Proposed

The Dodd-Frank Wall Street Reform and Consumer Protection Act[1] mandates that securitizers retain at least five percent of the credit risk in most securitization transactions. Last week, six federal agencies joined together to issue a Notice of Proposed Rulemaking (NPR) on the requirements for and exemptions from such risk retention. The rules are being proposed jointly by the Board of Governors of the Federal Reserve System, the Department of Housing and Urban Development, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission (collectively, the "Agencies"), and the releasing document includes requests for comments in numerous areas.

While we continue to digest all 376 pages of the release[2], we thought it worthwhile to point out a few of the key terms of the NPR and some initial questions we see. As we continue to evaluate the NPR and interact with our colleagues to prepare commentary, we will provide further sector-specific updates and insights for our clients and colleagues. Comments on the NPR are due by June 10, 2011. If you have any particular comments or concerns regarding the NPR, please contact your relationship attorney at Chapman and Cutler for further discussion. And in the meantime, stay tuned.

Permissible Forms of Risk Retention

The NPR describes several forms of risk retention that are permissible for asset-backed securities (ABS). Absent application of one of the exemptions provided in the NPR, securitization sponsors are required to retain economic interests in the securitization transactions they sponsor in any one of the following ways:

- **Vertical Risk Retention:** Not less than five percent of each class of ABS interest issued.
- **Horizontal Risk Retention:** An "eligible horizontal residual interest" in an amount at least equal to five percent of the par value of all ABS interests issued (including the residual interest).
  - An "eligible horizontal residual interest" is one that (i) has the most subordinated claim on cash flows, (ii) is allocated all losses until reduced to zero (except for losses covered out of excess spread, if any), and (iii) does not receive any payments of principal other than its current pro rata share of currently scheduled payments of principal.
  - This generally means that a residual interest intended to qualify as horizontal risk retention cannot receive distributions of its pro rata share of prepayments (until after senior classes are repaid).
  - *Unclear:* When can excess spread be applied to repay principal losses previously allocated to a retained residual?
  - Cash reserves fully funded at closing can be substituted for retention of a residual ABS interest. Amounts released to a sponsor cannot exceed the sum of earnings on the account plus principal payments received times ratio of current balance in cash reserve to remaining principal balance of all ABS interests.

  - *Unclear:* Can five percent horizontal risk retention be held partially in the form of a cash reserve and partially in the form of a residual ABS interest?

- **L-Shaped Risk Retention:** Not less than 2.5 percent of each class of ABS interest issued plus an eligible horizontal residual interest or horizontal cash reserve account at least equal to 2.564 percent of the par value of all ABS interests issued.

- **Seller's Interest in Revolving Master Trust:** A seller's interest of not less than five percent of the unpaid principal balance of all assets owned or held by the issuing entity, but only if (i) the issuing entity is a revolving master trust and (ii) all of the securitized assets are loans or other extensions of credit that arise under revolving accounts.

- **Representative Sample:** Retained ownership of a representative sample of assets randomly selected from the pool of assets designated for securitization and having an unpaid principal balance of at least 5.264 percent of the unpaid principal balance of the securitized pool.

  - Pool designated for securitization must have at least 1000 separate assets and must contain no assets other than those securitized and those retained in the sample pool;

  - Statistically valid methodology must be used to confirm that retained sample pool contains assets that have each of the material characteristic of the designated pool to a 95 percent degree of confidence;

  - Sponsor must have and adhere to policies and procedures and maintain documentation that establishes same and obtain an agreed upon procedures report to confirm the same;

  - Representative sample pool and securitized pool must be serviced by same person using same procedures; and

  - Representative sample pool must be retained and not hedged or securitized so long as ABS interests remain outstanding.

Asset-Related Exemptions from Risk Retention

Dodd-Frank mandated that the Agencies define a "qualified residential mortgage" for purposes of excluding securitizations of such mortgages from risk retention requirements. The NPR provides such a definition and also defines other types of loans which are also exempt from risk retention. Although the Agencies had the authority to provide for a sliding scale of risk retention, the following types of qualified loans all have zero percent required risk retention:

- **Qualified Residential Mortgage:** Generally defined as a mortgage loan secured by a first lien on a one to four family residential real estate that is fully performing at the time of securitization and that has documented evidence at origination of (i) maximum front end and back end borrower debt to income ratios of 28 percent and 36 percent respectively; (ii) maximum loan to value ratios (computed without regard to mortgage insurance) of 80 percent for purchase transactions, 75 percent for refinance transactions, and 70 percent for cash out refinance transaction; (iii) 20 percent down payment in the case of purchase transaction; (iv) no significant borrower delinquencies, defaults, or bankruptcies in recent periods prior to origination; and (v) maximum term of 30 years and no complex product features, including but not limited to no interest only or negative amortization features, no prepayment penalty, annual and lifetime caps on increases in variable rates do not exceed two percent and six percent respectively and points and fees do not exceed three percent.

  - Acceptable documentation for establishing compliance with each of the above criteria is described in an extensive appendix to the NPR.

  - Servicing guidelines applicable to QRM's must include guidelines for pursuing loss mitigation strategies (which guidelines are not specified in the NPR) and initiating such strategies within 90 days after delinquency.

- **Qualified Commercial Mortgage:** Generally defined as a mortgage loan secured by a first lien on real property consisting of either five or more single family units or other non-residential property that is expected to generate rent or sale proceeds and that at the time of origination has (i) minimum debt service coverage ratio of 1.75x (reduced to 1.5x for properties having a demonstrated history of stable net operating income);

(ii) maximum loan to value ratio of 65 percent (60 percent where the appraisal uses a low capitalization rate); and (iii) covenants requiring the borrower to maintain insurance at least equal to the lender's interest in the property.

- *Note:* Loans to finance land only or land development and construction are excluded.

- **Qualified Commercial Loan:** Generally defined as a secured or unsecured commercial loan that at the time of origination has (i) maximum total liabilities ratio of 50 percent; (ii) maximum debt to asset ratio of 3x; (iii) a minimum debt service coverage ratio of 1.5x; (iv) loan must amortize interest and principal on a straight line basis over no more than a five-year term; (v) primary source of payment must be revenues from the business; (vi) contains covenants to provide financial statements and limiting payments in kind and, if secured, that require maintenance of the collateral and limiting the grant of other liens on the collateral.

- **Qualified Auto Loan:** Generally defined as a loan made in connection with the purchase of an automobile that at the time of origination has (i) maximum front end borrower debt to income ratio of 36 percent; (ii) a borrower down payment of at least 20 percent plus title, tax, delivery, and closing costs; (iii) no significant borrower delinquencies, defaults, or bankruptcies in recent periods prior to origination; (iv) a fixed interest rate and maximum term of five years (or shorter if the vehicle is used); and (vi) straight line amortization and no provisions permitting deferral of principal or interest under the loan.

    - *Note:* Loans to finance fleet sales and commercial use vehicles are excluded, as are loans documented as leases (which presumably includes TRAC leases).

- **Other Types of Assets:** The Agencies note that although they have the authority to promulgate special rules for other asset classes, no such additional rules are planned at this time.

- **Additional Requirements:** In order to claim one of the above exemptions, securitized pools must be collateralized solely by qualified assets of the one type (and reserve accounts), and if, after closing, non-qualified assets are discovered, they must be repurchased by the sponsor.

Special Rules Related to Risk Retention Generally

Sponsors subject to risk retention with respect to a securitization are also subject to the following additional rules regarding such retained risk:

- **Premium Capture:** In addition to requiring the basic risk retention described above, under the NPR, sponsors would also be prohibited from realizing value at closing from "excess spread" (the excess of the interest rate earned on the securitized assets over that being paid on the ABS). This is accomplished by requiring the sponsor to deposit cash into a reserve account at closing in an amount equal to the excess of all proceeds received from the sale of ABS interests over 95 percent of par value of the ABS issued (100 percent in the case of ABS subject to the representative sample form of risk retention or the special rules for eligible ABCP conduits or CMBS described below).
    - Amounts deposited in the "premium cash reserve account" would be used to cover losses in the transaction before such losses are allocated to reduce principal of any ABS interest;
    - The reserve would be required to be maintained for the life of the transaction and is in addition to any other forms of required risk retention;
    - Gross proceeds are deemed to include the par value (or fair value if no par exists) for the retained interest held by the sponsor if (i) the retaining sponsor does not intend to hold the interest to maturity or (ii) the retained interest represents the right to receive interest distributions at a senior priority payment level and only minimal amounts of principal (except where the sponsor is using vertical or L-shaped risk retention).
    - *Note:* The stated purpose of premium capture is to prevent sponsors from extracting value for increased interest rates being charged to borrowers as compensation for additional credit risk associated with their loans. However, excess spread in securitizations can also be attributable to changes in market rates of interest between origination and securitization and the rule as currently written does not distinguish between the two.

- *Further note:* So far, this provision seems to be the biggest surprise in the NPR and is receiving much criticism from the mortgage side of the ABS industry.

- *Unclear:* Whether the rule applies beyond mortgage securitizations to other asset classes that have the potential to capture excess spread (such as equipment lease ABS and other forms of ABS sized off a discounted balance rather than a stated par value for the underlying receivables). Based on the wording of the rule itself, which compares proceeds to par value of ABS interests issued (rather than basis in securitized assets or ABS interests issued), it would appear that premium capture will not apply to all such situations.

- **Hedging:** Sponsors are not permitted to sell, assign, finance, or hedge interests required to be retained as risk retention in a securitization except for (i) transfers to affiliates included in the same consolidated group for financial statement purposes, (ii) financing that is fully recourse, and (iii) hedging of risks related to interest, currency, overall home prices, or overall values of categories of ABS. These same rules apply to retained interests held by seller/originators to ABCP conduits and third-party purchasers of first loss CMBS (described below).

- **Disclosure:** The NPR mandates specific types of disclosure to investors for each type of risk retention.

Other Special Rules

Each of the following types of securitizations or sponsors are subject to additional special rules under the NPR.

- **Asset-Backed Commercial Paper:** Although ABCP conduits are not exempted from risk retention, in the case of an "eligible ABCP conduit", risk retention can be satisfied by the seller retaining an "eligible horizontal residual interest" in its intermediate SPV and complying with the limitations on hedging and non-recourse borrowing with respect to such retained interest.

  - An eligible ABCP conduit is defined as one that is (i) bankruptcy remote, (ii) has 100% liquidity coverage from a regulated liquidity provider; (iii) holds interests issued by one or more intermediate SPVs, which interests are collateralized solely by assets originated by a single originator/seller; and (iv) all interests issued by the intermediate SPV are transferred to one or more ABCP conduits or retained by the originator/seller.

  - *Unclear:* Whether ABCP conduits that hold interests in assets originated by multiple affiliated originators or that hold senior interests along side non-conduit investors are intended to be excluded.

  - The conduit is also required to make ongoing disclosures to its investors regarding seller retained interests, monitor compliance with same, and report any failures by the seller in so complying. *Note:* Making such ongoing disclosures regarding risk retention in advance of each issuance of commercial paper may present operational challenges for conduit sponsors.

- **Commercial Mortgage-Backed Securities:** In the case of CMBS transactions, risk retention can be satisfied by a sponsor having an unaffiliated third party purchaser acquire an "eligible horizontal residual interest" at closing so long as:

  - at least 95 percent of the total unpaid principal balance of the securitized pool consists of commercial real estate loans;

  - the third-party purchaser pays cash for the residual interest and such cash is not loaned to it by another party to the transaction (such as sponsor or servicer);

  - the third-party purchaser conducts its own credit review of each loan in the securitized pool;

  - the third-party purchaser is not related to any other party to the transaction (such as sponsor or servicer) and has no control rights that are not collectively shared with other investors in the transaction unless an independent "operating advisor" is appointed in the transaction. The operating advisor is required to act for the benefit of all investors and must be consulted prior to certain material decisions involving servicing (such as loan workouts or servicer replacements).

- **Multiple Sponsors:** If there is more than one sponsor of a securitization, each sponsor is responsible for making sure that at least one of the sponsors retains an economic interest in the securitized assets that satisfies the risk retention requirements.

- **Other Exempt Issuers:** The NPR also exempts each of the following types of issuers and/or ABS from risk retention: (i) ABS collateralized by obligations issued by or insured or guaranteed by the United States; (ii) ABS issued by the United States or any subdivision thereof that is exempt from registration under Section 3(a)(2) of the '33 Act; (iii) ABS interests that are themselves insured or guaranteed by the United States; (iv) ABS collateralized by assets made, insured, guaranteed, or purchased by institutions supervised by the Farm Credit Administration; and (v) ABS that constitute qualified scholarship funding bonds. So long as the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation are under conservatorship, their ABS is treated as guaranteed by the United States, and they are thus exempted from risk retention.

Effective Dates

For RMBS, the rules are currently proposed to become effective one year after the date on which final rules are issued, and for all other types of securitizations, two years after the date on which final rules are issued.

Endnotes

1. Pub. L. No. 111-203, 124 Stat. 1376 (2010). See Section 941(b), which is now codified as Section 15G of the Securities Exchange Act of 1934 and appears at 15 U.S.C. §78o-11. Those provisions generally require the foregoing agencies to jointly prescribe regulations that (i) require a securitizer to retain not less than five percent of the credit risk of any asset that the securitizer, through the issuance of an asset-backed security, 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 such rules.

2. The Notice of Proposed Rulemaking can be found at http://www.fdic.gov/news/board/29Marchno2.pdf.

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