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White Paper

Overview of the Re-Proposed Credit Risk Retention for Securitizations

Overview of the Re-Proposed Credit Risk Retention Rule for Securitizations

Following the relatively controversial reception received by their original proposed rules (reflected in the over 10,000 comment letters received), the SEC and various banking and housing regulators have re-proposed the credit risk retention rules that generally require securitization sponsors to retain a minimum portion of the credit risk in the assets that they securitize. In this summary, as in our prior summary[1] that reviewed the original proposed rules, we highlight the differences between the original proposed rules and the recently re-proposed rules, discuss a number of provisions that are unclear or problematic and offer a preliminary assessment of the impact of the rules on the securitization markets.

Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) amended the Securities Exchange Act of 1934 by adding thereto a new section 15G (Section 15G), which generally requires any sponsor or securitizer of asset-backed securities (ABS) to retain at least 5 percent of the credit risk of the assets supporting its securities. It also generally prohibits the sponsor from eliminating or reducing its credit exposure by hedging or otherwise transferring its required retained credit risk. Section 15G exempts certain types of assets from the risk retention requirements and authorizes the implementing regulators to exempt or establish a lower risk retention requirement for other types of assets.

On August 28, 2013, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Securities and Exchange Commission (Commission) and, with respect to the portions addressing residential mortgage assets, the Federal Housing Finance Agency (FHFA) and the Department of Housing and Urban Development (HUD) (together, Joint Regulators), issued a second Notice of Proposed Rulemaking[2] (Re-Proposal) that would, if finalized, implement the risk retention requirement of Section 15G. The Joint Regulators initially proposed a similar rule on April 29, 2011 (Original Proposal) and received comments from more than 10,500 individuals, organizations and groups, including over 300 unique comment letters. In response to those

comments, the Joint Regulators have issued the Re-Proposal and solicited additional comments by October 30, 2013.

In this high-level summary, we outline the key revisions and new provisions of the rule, as well as highlight certain related challenges facing the industry. Given the length and complexity of the Re-Proposal, this summary does not attempt to describe every important provision; rather, it is intended to put the Re-Proposal in context and to stimulate discussion.

This summary discusses the Re-Proposal in three parts: Part I addresses core issues and general provisions; Part II addresses particular asset classes, namely, residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), collateralized loan obligations (CLOs), commercial loans, automobile loan securitizations, asset-backed commercial paper conduits (ABCP Conduits), master trusts, student loans, municipal bond repackaging transactions, resecuritizations, seasoned loans and utility legislative securitizations; and Part III addresses international transactions.

I. CORE ISSUES AND GENERAL PROVISIONS

A. Changes in Retention Methods

Among the most important changes introduced by the Re-Proposal are those to the available methods that sponsors can use to comply with the standard risk retention requirement. Under the Original Proposal, sponsors were required to hold 5 percent of the par value of each class of ABS interests (Vertical Retention or Vertical Method), a 5 percent of par value first-loss tranche (Horizontal Retention or Horizontal Method) or an L-shaped 50-50 combination of the two. The Re-Proposal provides maximum flexibility to sponsors to combine Horizontal Retentions and Vertical Retentions in any proportion necessary to achieve the required risk retention percentage of 5 percent of the *fair value* or the ABS interests issued by the issuing entity (note, the change from par value to fair value is a significant revision discussed more fully in Part I.B below). As a form of Horizontal Retention, sponsors may satisfy all or a portion of their required risk retention by opening a fully funded cash reserve account with a trustee.

The Re-Proposal has eliminated the Original Proposal's representative sample option in its entirety. The removal of this option may have significant adverse effects for banks and other issuers who rely on the sale of their residual interests to obtain sale treatment for accounting purposes (as is currently required under

certain regulatory safe harbors). As currently proposed, the definitions of eligible vertical interest and eligible horizontal residual interest require the sponsor to retain some interest in the issuing entity, which is likely to result in the consolidation of the issuing entity with the sponsor under both US GAAP and IFRS. The Joint Regulators requested comment on whether the representative sample option should be restored. Given its potential utility for critical accounting purposes, this is an excellent object for industry attention.

With respect to Horizontal Retention, the Re-Proposal provides that "eligible horizontal residual interests" may be in a single class or multiple classes but clarifies that such interests must absorb any resulting cash flow shortfalls prior to any reduction in the amounts paid to any other ABS interest issued by the issuing entity.

Comments to the Original Proposal raised concerns about the prohibition on making payments of unscheduled principal payments to eligible horizontal residual interests in transactions that do not customarily separate collections into interest, scheduled principal and unscheduled principal. To address these concerns, the Re-Proposal substituted the former prohibition with an additional requirement. On the closing date of the securitization, any sponsor utilizing Horizontal Retention must calculate the projected cash flow rate on the eligible horizontal residual interest (including any amounts released to the sponsor on any horizontal cash reserve account), as well as the projected principal repayment rate for all other ABS for each payment date. The sponsor must certify to investors that, for any payment date, the projected cash flow rate on to the eligible horizontal residual interest (or amounts released to the sponsor on any horizontal cash reserve account) for each payment date does not exceed the projected principal repayment rate for the other ABS interests for such payment date.

With respect to Vertical Retention, the Re-Proposal provides that an "eligible vertical interest" may be a single vertical security, rather than multiple securities representing separate interests in each class of ABS interests or an interest in the specified percentage of each of the other ABS interests issued by the issuing entity.

In one important item regarding Vertical Retention, several commenters had requested that a participation interest be included as a permissible method for sponsors to satisfy their risk retention requirements. While the Re-Proposal included the single vertical security as a form of Vertical Retention, this proposed

vertical interest is likely not a participation interest in the securitized assets under applicable standards. Further expansion of this definition to permit a qualifying participation interest in the securitized assets would expand sponsors' structuring options materially yet not alter the nature of the sponsors' retained risk in the securitized assets.

B. Fair Value and Deletion of Premium Capture Cash Reserve Account

Based on significant comments to the Original Proposal, the Re-Proposal has removed the premium cash capture reserve account (PCCRA) concept in exchange for changing the standard risk retention requirement from a percentage of the par value to a percentage of the fair value. The fair value of the ABS interests would be determined generally in accordance with GAAP. While many will welcome the removal of the PCCRA requirement, others are likely to be concerned that this change may introduce significant uncertainty if there are no means to readily and accurately determine such fair value (for example, where a sponsor retains the entire equity/first-loss interest or where a tranche is not issued or traded).

In order to ensure that investors understand the risk retained by the sponsor, the Re-Proposal requires sponsors to provide additional disclosure to investors, including the material terms of the ABS interests retained, the methodology used to calculate the fair value; the key inputs, assumptions and reference data and historical information used in calculating the fair value. Additionally, for sponsors using the Horizontal Method, information about the sponsors experience in retaining interests under the Horizontal Method and the number of payment dates in prior securitizations in which the actual payments to the sponsor exceeded the cash flow projected to be paid to the sponsor on such payment date.

C. Risk Retention by Affiliates of Sponsor

In response to significant industry comment, the Re-Proposal provides that the retained risk interest may be held by one or more majority-owned affiliates of the sponsor. Majority-owned generally means more than 50 percent ownership interest in the entity as determined under GAAP.

D. Blended Pools

The Re-Proposal retains the Original Proposal's exemption for ABS supported by qualifying loans – certain types of high-quality assets that satisfy specified underwriting criteria. Some commenters to the Original Proposal were concerned, however, because, in order to qualify for the exemption, a securitization had to be backed solely by qualified assets. Given how stringent the underwriting criteria were, many felt that qualified assets would not be originated in sufficient quantities to support a vibrant securitization industry in that asset type. In response, the Re-Proposal has broadened some of the criteria (as more fully discussed in Part III) and would allow blended pools in certain asset classes, namely, qualified commercial real estate loans (QCRE), qualified commercial loans and qualified automobile loans.

The risk retention requirements for securities based on these blended pools are reduced by the proportion of loans that are qualifying loans to the total unpaid principal balance of the pool. The Re-Proposal provides that the ratio of qualifying loans to the entire pool cannot exceed 50 percent unless all of the securitized assets are qualifying assets. It is worth noting that the release suggests that such blended pools would be subject to a minimum required risk retention percentage of 2.5 percent and does not include the 50 percent limitation on ratio of qualifying to total assets. We note that the provisions of the release provide more structuring flexibility and would only cause an increase in the incremental required risk retention percentage for any qualifying assets in excess of the 50 percent limitation.

A sponsor does not automatically lose the benefit of the blended pool or qualifying asset exception if it is determined after closing that certain of the assets did not satisfy the specified underwriting criteria. As an initial matter, the failure of a loan to satisfy the underwriting requirements must be material. In the event that the loan does materially deviate from the specified underwriting criteria, the sponsor may preserve the benefit of the exception by either curing the underwriting deficiency or buying back the asset within ninety days.

E. Duration of Hedging and Transfer Restrictions

Generally, the restrictions on the hedging or transfer of a sponsor's retained risk will expire on the latest of (i) two years after closing, (ii) when the principal balance of the pool is 33 percent or less than the original balance or (iii) when the unpaid principal amount of the related ABS interests is 33 percent or less than the original amount.

The Re-Proposal provides special sunset rules for RMBS and CMBS transactions, as more fully described in Parts II.A.4 and II.B.1.c, respectively, below.

F. Hedging Restrictions

Consistent with the Original Proposal, the Re-Proposal generally prohibits hedging of the retained risk. Both proposals provide that non-credit risks, such as interest rate or FX risk, may be hedged. The Re-Proposal also allows credit risk hedging through the use of index instruments and the retained credit risk related securitization is no more than 10 percent of the index, and the aggregate of all of the sponsor's securitization transactions for which it is required to retain credit risk must constitute no more than 20 percent of the index.

II. DISCUSSION BY ASSET CLASS

A. Residential Mortgage-Backed Securities

With respect to residential mortgages, the Re-Proposal provides several new and revised provisions that will have a significant impact on the residential mortgage securitization industry.

1. *QRM*

The definition of a "qualified residential mortgage" (QRM), which defines residential mortgage loans exempt from the standard risk retention requirement, has been revised to mean a "qualified mortgage" (QM), as defined in section 129C of the Truth In Lending Act that is not currently more than thirty days past due.

This material revision followed significant comment from the industry that requiring compliance with two separate standards – QM for purposes of the Truth In Lending Act and QRM for risk retention – would be unnecessarily burdensome.

As the Re-Proposal links QRM to QM, the limitations on the definition of QM will apply to QRM, including the following:

1. regular periodic payments that are substantially equal;
2. no negative amortization, interest-only or balloon features;
3. maximum loan term of thirty years;
4. total points and fees do not exceed 3 percent of total loan amount;

5. payments underwritten using the maximum interest rate that may apply during the five years after the date on which the first regular periodic payment is due;
6. consideration and verification of the consumer's income and assets (including employment status, if relied upon), current debt obligations, alimony and child support;
7. total debt-to-income ratio does not exceed 43 percent, including mortgage-related obligations; and
8. residential mortgage loans that are eligible under GSE guidelines qualify as QMs without regard to the preceding requirements.

In addition, QRM (consistent with QM) would exclude HELOCs, reverse mortgages, timeshares, temporary loans or bridge loans of twelve months or less, and most loan modifications (unless they satisfy certain requirements).

Under the Re-Proposal, a securitization transaction would not become ineligible for the QRM exemption if the sponsor discovers after closing that one or more of the mortgages do not comply with the QRM requirements, provided (1) the depositor must have certified as to the effectiveness of its internal supervisory controls, (2) the sponsor must repurchase the loans determined not to be QRMs from the issuing entity at a price at least equal to the remaining balance and accrued interest not later than ninety days after it is determined the loans do not satisfy QRM requirements, and (3) the sponsor must cause prompt notice to be given to ABS holders of any loans required to be repurchased. Notably, unlike the qualifying asset exceptions for qualifying commercial loans, CRE and automobile loans, there is no materiality threshold and no ability for the sponsor to cure any such noncompliance. While this may not be a significant concern under the Re-Proposal, such omissions may become more detrimental if the QRM definition tightens in accordance with the QM-Plus alternative described below or otherwise.

Unlike the Original Proposal, the Re-Proposal's linkage of the definition of QRM to QM means that, as proposed, there will be no minimum down payment requirement for a QRM. In light of this and other concerns expressed by certain Joint Regulators, the Re-Proposal solicits comments regarding an alternative QRM approach, called "QM-Plus," that would start with the core QM principles and add the following standards: (1) a maximum 70 percent loan-to-value ratio;

(2) collateral must be first liens on the borrower's principal dwelling for purchase loans, but refinance loans could have junior liens subject to the loan-to-value ratio requirement on a combined basis; and (3) credit history metrics regarding delinquencies and other legal actions.

2. *Special Beneficial Impact of the Removal of PCCRA for RMBS*

While the removal of the PCCRA affect the securitization industry generally, these revisions were highly sought after by originators and securitizers in the residential mortgage securitization industry given the customary premium value of high-quality residential mortgage loans and the adverse effects that the PCCRA would have had on the efficiency and continued reinvigoration of residential mortgage securitization industry.

Such effects, along with the narrower definition of QRM in the Original Proposal, were viewed by some market participants as potentially offering the GSEs a significant comparative advantage versus the private secondary residential mortgage securitization industry, potentially significantly impeding the FHFA and other policy makers to achieve its mandate to reduce the GSE's share of the new origination market without jeopardizing the nascent signs of recovery in residential property values in many areas.

3. *No Blended Pools*

The Re-Proposal failed to include residential mortgages within the product types that could establish blended pools as described in Part I.D above. Although perhaps not as significant of an initial concern, given the Re-Proposal's linkage of the definition of QRM to QM, the possibility of further revision of the definition of QRM along the lines of the QM-Plus described above, as well as potential future changes to the definition of QM, may make the establishment of such blended residential mortgage pools beneficial to the development of a private secondary market for residential mortgages that are not QRMs but are QMs.

4. *Special Rule for Termination of Hedging and Transfer Restrictions*

Unlike other asset classes, the Re-Proposal provides a special rule for residential mortgages, providing for the termination of such restrictions at the later of (x) five years, rather than two years, following closing and (y) the date when the unpaid principal balance of the residential mortgages has been reduced below 25

percent of the initial aggregate unpaid principal balance, rather than the date when the unpaid principal obligation of the ABS interests have been reduced to 33 percent of the initial principal obligation thereof.

Although this special rule appears to require the hedging and transfer restrictions to last much longer for residential mortgage transactions, it also provides that such restrictions terminate automatically seven years following the closing date regardless of the principal balance of the underlying loans. This may prove shorter than the termination date that would have applied for certain pools under the general rule described above.

B. Commercial Mortgage Backed Securities and Commercial Real Estate

1. *CMBS Option Or "B-Piece Option"*

The Re-Proposal would allow up to two third-party purchasers (B-Piece Buyer) to satisfy the risk retention requirement through the purchase of an eligible horizontal residual interest (such interest, the B-Piece, and such option, the B-Piece Option). Under the Original Proposal, the entire B-Piece was required to be held by one B-Piece Buyer. Under the Re-Proposal, each B-Piece Buyer's interest must be *pari passu* with the other B-Piece Buyer's interest, so that neither B-Piece Buyer's losses are subordinate to the other's losses, and each B-Piece Buyer would be required to conduct an independent review of each asset in the pool. Moreover, the Re-Proposal clarifies that the B-Piece Option can be used in combination with a Vertical Retention held by a sponsor.

The Re-Proposal retains restrictions on financing and hedging the credit risk of the B-Piece.

a. *Operating Advisor Requirement*

The Re-Proposal requires that an independent operating advisor (Operating Advisor) be appointed for any securitization on which the sponsor uses the B-Piece Option. Under the Original Proposal, an Operating Advisor was required only if the B-Piece Buyer was affiliated with, or had certain control of servicing by, the servicer. The Operating Advisor may not be affiliated with other parties to the transaction and cannot have any financial interest in the transaction other than its fees as Operating Advisor.

Under the Re-Proposal, the Operating Advisor's authority is limited to special servicers, and the consultation rights with respect to major investing decisions arise only after the B-Piece Buyer control period has ended (once the principal balance of the B-Piece is reduced to 25 percent or less of its initial principal balance). This is unlike the Original Proposal, which provided that the Operating Advisor provisions could apply to any servicer, including the master servicer and certain primary servicers and allowed for consultation rights during the B-Piece Buyer's control period.

The Operating Advisor's authority to remove and replace the servicer under the Re-Proposal would apply only to special servicers, and 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. This removal authority as contemplated by the Re-Proposal starts at the closing of the securitization as opposed to only after the B-Piece Buyer's control period is over. Under the Original Proposal, after an Operating Advisor recommended the termination of the servicer, that termination would become effective unless a certain percentage of investors voted not to terminate. The Re-Proposal requires an affirmative vote of investors to terminate.

b. *Disclosure*

If the B-Piece Option is utilized, the Re-Proposal requires specific disclosure about the B-Piece Buyer and the B-Piece as well as disclosure similar to that required by sponsors with respect to ABS interests generally as described in Part I.B above.

c. *Transfer Restrictions*

The Original Proposal would have required the B-Piece Buyer to hold the B-Piece (and comply with the hedging restrictions) for the life of the deal, whereas the Re-Proposal allows both (i) successive transfers of the B-Piece and (ii) in a securitization in which the sponsor retained the B-Piece at closing, a transfer of such interest to a purchaser satisfying the criteria applicable to B-Piece Buyers, in each case at any time after five years after the date of the closing of the securitization transaction.

2. *“CRE Loan” Definition*

The definition of “CRE loan” under the Re-Proposal includes two important modifications to the definition in the Original Proposal. The source of repayment of the loan can now include rental income from affiliates of the borrower if the ultimate income stream for repayment comes from unaffiliated parties (for example, in a hotel, dormitory, nursing home, or similar property), where the Original Proposal did not allow the source of repayment to include rental income from affiliates of the borrower. The definition was also revised to remove the exclusion of loans to REITs, which were previously prohibited. The CRE loan definition under the Re-Proposal continues to exclude “land loans.”

3. *Qualifying CRE (QCRE) Exemption*

Under the Re-Proposal, a multifamily CRE loan must have a 1.25 DSCR to be QCRE (reduced from 1.5 in the Original Proposal), and for other CRE loans, the Re-Proposal retains the 1.5 DSCR for leased QCRE loans and 1.7 for all other QCREs, in each case, based on two years of historical data collection and two years of forecasted data.

The interest rate on a QCRE loan must be fixed or fully convertible into a fixed rate using a derivative product. No interest-only loan or loan with an interest-only period can be a QCRE loan. The amortization period for a QCRE loan must be no more than thirty years for multifamily loans and twenty-five years for all other QCRE loans(in each case, increased from twenty years in the Original Proposal), in each case based on straight-line amortization. The maximum LTV ratio for a QCRE loan is 65 percent and the maximum CLTV ratio for a QCRE loan is 70 percent (increased from 65 percent in the Original Proposal). If the cap rate used in valuation is less than a prescribed rate, the maximum LTV ratio is 60 percent and the maximum CLTV ratio is 65 percent, and the cap rates used in the valuations must be disclosed.

4. *“Non-Conduit” CMB*S

The Re-Proposal does not include an exemption for “non-conduit” CMBS deals (i.e., single asset/single borrower/large loan deals). This is problematic for the market because it will be difficult for the B-Piece Option to be used with “non-conduit” CMBS.

C. Collateralized Loan Obligations (CLOs) and Qualifying Commercial Loans

For CLOs, the Joint Regulators specifically rejected comments asserting that the CLO manager of an open market CLO is not a "securitizer" and therefore should not have to retain risk. Instead, the Joint Regulators construed the text of Section 15G to find that a CLO manager for an open market CLO is a "securitizer" because it indirectly selects assets for the CLO entity to acquire and, as a result, is subject to the required risk retention. The Joint Regulators acknowledge that this may result in fewer CLO managers (as smaller CLO managers are forced to sell or merge) and may create a barrier to entry for new CLO managers.

The Re-Proposal introduces a new exemption for open market CLOs that is satisfied if (i) the "lead arranger" of the related securitized loan or credit facility holds a 5 percent or more interest in a "CLO-eligible loan tranche" of a syndicated credit facility to be designated at the time of closing of such facility and (ii) the open market CLO only holds CLO-eligible loan tranches and related "servicing assets." Implementing this exemption in practice would substantially impact current market practices in the syndicated credit and CLO markets. It is unclear whether lead arrangers will be willing to hold such required retention interests and otherwise to comply with this proposed exemption and, even if they do so, whether they will want to be compensated for doing so. It is also unclear whether this requirement will negatively impact the economics for a related CLO. Many view this new lead arranger risk retention option as impractical and unworkable, and affected CLO market participants are expected to suggest a significant expansion and revision thereof in order to avoid material disruption to existing CLO and syndicated loan markets.

The Re-Proposal includes related specific requests for comment regarding alternative proposals to determine the applicable lead arranger, who should be responsible for ensuring that the lead arranger maintains the required interest and how this might be evidenced.

Non-open market CLOs cannot use the new exemption and are subject to the general requirements regarding risk retention.

The Re-Proposal also modifies the exemption from the risk retention requirements for "qualified commercial loans." In a departure from the Original Proposal, first-lien collateral is not required unless the loan is intended to finance a piece of property, although it now specifies that any security interests must be

perfected promptly after origination at the latest. Additionally, the Re-Proposal permits sponsors to cure material defects in loans that are later determined not to be qualified loans – not merely to repurchase them.

D. Automobile Loan Securitizations

The Re-Proposal made several modifications to the definition of "qualified automobile loan." These modifications include:

1. A requirement that the originator verify the borrower has at least twenty-four months of credit history;

2. A reduction in the maximum permissible age of the borrower's credit report from ninety to thirty days;

3. A reduction in the minimum down payment from 20 percent to 10 percent but with the addition of the price of additional warranties, insurance or other products purchased;

4. The borrower must make equal monthly payments that fully amortize the loan over a term not to exceed six years from origination date for new cars or ten years minus the difference between the current model year and the vehicle's model year for used cars; and

5. As with other types of exempted assets, the Re-Proposal permits sponsors to cure material underwriting defects in assets within ninety days, rather than requiring repurchase of the assets.

The initial indication from the industry is that the Qualified Automobile Loan exemption is unworkable as currently drafted for the following reasons:

1. The requirement that all automobile loans must be contractually current as of the closing date of the securitization is impossible – requirements of this type must be applied as of the cutoff date; and

2. The down payment requirement would require significant changes to consumer automobile lending because many prime automobile loans do not have down payments.

More broadly, the changes to definition of eligible horizontal residual interest will be helpful to automobile loan securitization deals. The Original Proposal would have been usable for automobile loan securitizations as it would have required

multiple waterfalls and other cumbersome changes to the structures currently in use.

E. Asset-Backed Commercial Paper

With respect to ABCP Conduits, the Re-Proposal provides an exemption from the risk retention requirements for "eligible ABCP conduits." The Re-Proposal made several revisions that modified certain of the requirements of the exemption from the risk retention requirement for eligible ABCP Conduits to better conform to customary industry practices.

These significant revisions include the following:

1. the development of a "majority-owned OS affiliate" concept permitting originator-sellers to sell assets through a majority-owned OS affiliate to the Intermediate SPV and to retain any relevant required retained interests directly or, evidently, through a majority-owned OS affiliate. The Re-Proposal defines majority-owned OS affiliate as an entity that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, the originator-seller;

2. the removal of the requirement that all interests issued by an intermediate SPV must be issued to one or more ABCP Conduits, which prohibited intermediate SPVs to issue interests to banks and other funding sources;

3. the removal of the requirement to disclose the originator-seller (or majority-owned OS affiliate) that will retain (or has retained) an interest in the ABS interests acquired by the eligible ABCP Conduit unless such originator-seller defaults in its risk retention obligations; and

4. broadening the assets that may collateralize the asset-backed securities acquired by an eligible ABCP Conduit to include special units of beneficial interests in trusts related to leased property and interests in revolving master trusts.

Importantly, the Joint Regulators did not make certain material revisions sought by industry participants, including:

1. the ABCP Conduit retaining sponsor being obligated to monitor originator-seller compliance with retention requirements; and

2. the exclusion of ABCP Conduits that are aggregators of secondary market asset-backed securities from the benefits of the exemption.

In addition, the re-proposal contains an explicit requirement that was not in the original proposal that provides that (i) the sponsor-provided 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 (ii) liquidity support that only funds performing receivables and performing ABS interests does not meet the requirements of the ABCP conduit exemption. This would mean that partially supported ABCP conduits would not be eligible for the ABCP conduit exemption.

Also, the re-proposal provides that an eligible ABCP conduit may be collateralized solely by asset-backed securities acquired from an intermediate SPV and servicing assets. This would mean that ABCP conduits availing themselves of the special exemption could not also fund non-ABS interests.

If a conduit does not meet the requirements of the exemption, the retention requirement must be satisfied by using any of the means available to securitizers generally. Conduit sponsors were not provided any relief for the requirement that retained risk must be fully funded, even if the sponsor provides 100 percent full support liquidity to the conduit.

Also, conduit sponsors and customers alike should be mindful that the retention requirements will apply to many conduit transactions even if they are purely private and bilateral.

F. Master Trusts

The Joint Regulators have modified the Original Proposal with respect to master trusts as follows:

1. As in the Original Proposal, the Re-Proposal provides that a sponsor of a master trust securitization will satisfy the risk retention requirements if the sponsor retains a seller's interest of not less than 5 percent. However, in the Re-Proposal the seller's interest option is to be based on the unpaid principal balance of all outstanding investors' ABS interests issued in all series, as opposed to the unpaid principal balance of all the assets owned or held by the issuing entity, as was originally proposed.

2. The Joint Regulators have attempted to harmonize the definition of seller's interest and master trust with market practice, and have removed the restriction in the Original Proposal that limited the seller's interest option to master trusts that issued ABS backed only by revolving assets (though the Joint Regulators have not addressed concerns expressed in prior industry comment letters with the requirement that the seller's interest be a *pari passu* interest as noted below).

3. The Re-Proposal allows for the required risk retention interest in a master trust to be held by the sponsor or any wholly owned affiliate of the sponsor, including any depositor.

4. The Re-Proposal allows the seller's interest to be retained in multiple trusts in order to address legacy trusts that issue collateral certificates to newer issuing trusts.

5. The Original Proposal did not allow for combining risk retention methods for revolving master trusts, whereas the Re-Proposal allows for a combination of the seller's interest option and an eligible horizontal residual interest. The 5 percent seller's interest required on each measurement date will only be reduced to the extent the sponsor or a wholly owned affiliate of the sponsor retains a corresponding percentage of the fair value of all ABS interests issued in each series in the form of an eligible horizontal residual interest issued for each series (in other words, a first-loss exposure for every series issued by the master trust).

6. Any eligible horizontal interest must have a claim to the series' share of interest and fee cash flows that is subordinated to all interest and principal payments due to more senior ABS interests, as well as the series share of losses, and must have a subordinated claim to any part of the series' share of principal repayment cash flows. This would seem to preclude a subordinated retained interest that is entitled to interest payments payable from a finance charge waterfall prior to coverage of losses and payments of principal for investor interests. The release indicates that the Joint Regulators intended to recognize the fair value of the sponsor's claim to excess spread as a permissible form of horizontal risk retention for revolving master trusts.

7. The Re-Proposal rejects the request made in various comment letters to grandfather securities issued by master trusts prior to the effective date for the risk retention rules.

8. The Re-Proposal provides that a sponsor will not violate the risk retention requirement if the seller's interest falls below the required level during an early amortization period if (among other requirements) the sponsor was in full compliance with the risk retention requirements on all measurement dates prior to the event of default that triggered the early amortization event.

9. The Re-Proposal allows for a dollar-for-dollar offset against the 5 percent seller's interest requirement for amounts deposited in a pool-level excess funding account that is funded to cure a shortfall in the minimum seller's interest requirements under the securitization transaction documents, but only if, in the event of an early amortization event, amounts in the excess funding account are used to make payments to holders of investors' ABS interests in the same manner as collections on the securitized assets. The Re-Proposal also includes a requirement that the excess funding account be *pari passu* to each series of investors' ABS interests with respect to the allocation of losses with respect to the securitized assets prior to an early amortization event. This last requirement may be problematic for a typical master trust that does not allocate losses to the excess funding account.

As in the Original Proposal, the seller's interest option continues to require the seller's interest to be *pari passu* to each series of investors' ABS interests issued with respect to the allocation of all distributions and losses with respect to securitized assets prior to an early amortization event. The Joint Regulators do not appear to have addressed the concern expressed by a number of commenters that the requirement that the seller's interest be *pari passu* could be interpreted to disqualify a seller's interest in a transaction in which allocations of principal collections become "fixed" based on the initial principal balance of the ABS interests for the duration of the scheduled amortization period or accumulation period (arguably subordinating the sponsor's share of principal collections). Such an interpretation would prevent virtually all seller's interests as currently structured in the credit card securitization market from satisfying the risk retention requirements. However, the release indicates that the Joint Regulators

are considering whether they should make additional provisions for subordinated seller's interests.

G. Student Loans

In response to comments made on the Original Proposal, the Re-Proposal eliminates or reduces the required retention amount for certain student loans. Student loans originated under the Federal Family Education Loan Program (FFELP) enjoy varying degrees of federal guarantees, and their retention requirements are adjusted accordingly. For loans that are fully guaranteed by the Federal Government, no risk retention is required. If a loan is not 100 percent guaranteed, but is at least 98 percent guaranteed, the Re-Proposal would require a 2 percent risk retention while all other FFELP loans would be subject to a 3 percent retention.

H. Miscellaneous

1. *Municipal Bond Repackaging (or Muni TOBs)*

The Re-Proposal addresses, for the first time, the particular features of municipal bond repackagings, specifically giving sponsors of certain tender option bond transactions (TOBs) new risk retention options. In addition to the standard risk retention options, TOB sponsors may retain an interest that meets the requirements of a Horizontal Retention when the bonds are issued that would change to a Vertical Retention upon the occurrence of a "tender option termination event" as defined in Section 4.01(5) of IRS Revenue Procedure 2003-84. The sponsor of a tender option bond entity may also hold municipal securities from the same issuance that it deposits in the qualified tender option bond entity with a face value of 5 percent of the securities that it deposits. In order to take advantage of these additional options, a tender option bond issuer must have a 100 percent guarantee or liquidity facility provided by a regulated liquidity provider. Initially, the new option appears to only benefit a portion of the current TOB market; affected industry participants are expected to seek an expansion of this additional risk retention option to permit current and expected TOB practices.

2. *Resecuritizations*

With respect to resecuritizations, the Re-Proposal offers an additional exception for resecuritization transactions.

First-pay class resecuritizations have been added as an additional category of exempted transaction so long as the resecuritization transaction is collateralized solely by first-pay classes of asset-backed securities backed by first lien residential mortgage loans.

This narrow expansion of the exemption for resecuritization importantly permits any such transaction to reallocate prepayment risk but unfortunately does not permit reallocation of credit risk or realized losses other than in a pro rata fashion or the issuance of an inverse floater ABS interests.

This modest expansion does not address concerns of several market participants, from the structuring, broker dealer and investor perspectives, to permit resecuritization in order to reallocate credit risk on the resecuritized ABS interests or to permit resecuritization of ABS interests created prior to the effectiveness of the risk retention rules.

3. *Seasoned Loans*

The Joint Regulators provided some flexibility as it relates to the securitization of seasoned loans – i.e., loans that have been outstanding for some time, that have not been modified and that have a good payment history. The requirement that the seasoned loans must not have been modified or have been thirty days delinquent since origination, as well as the significant seasoning requirement, will likely mean that this modest expansion is of little practical benefit. Unfortunately, this may have a detrimental impact on the expanding seasoned and reperforming residential mortgage securitization market that does not appear to be offset by any likely beneficial impact on origination practices.

4. *Utility Legislative Securitizations*

In response to comments made in connection with the Original Proposal, the Joint Regulators have proposed to exclude certain offerings by regulated investor-owned utilities that are supported by the utilities' right to collect charges for the recovery of specified costs (commonly known as stranded cost or rate reduction bonds). These stranded cost securitizations must be specifically authorized by a state legislature and public service commission after a finding that the securitization is in the interest of the utility and its customers. In addition, the payment streams supporting these securities must be set by the sponsor's regulator, and utilities do not have discretion to select which

customers' payments will be pooled and securitized. Thus, risk retention requirements would not improve the quality of the underlying assets because the sponsor has only minimal discretion in structuring the deal.

III. INTERNATIONAL TRANSACTIONS

The provisions of the Re-Proposal with respect to the safe harbor for certain qualifying non-US transactions has remained largely unchanged from the Original Proposal, except for certain modest technical amendments to the calculation of US versus non-US interest and for certain repeated changes to remove express use of dollar references in the Re-Proposal and to revise certain similar provisions that proved problematic for international transactions (such as the expansion of eligible assets that funds in an eligible horizontal reserve account may invested in if the ABS interests or securitized assets are denominated in a currency other than US dollars).

In addition to the lack of relief in the foreign safe harbor, it is noteworthy that the US retention requirements continue to differ from those outside the US—most notably Article 122a of the EU Capital Requirements Directive (CRD 122a) and its modifications—in several important respects:

1. the special rules for certain qualifying assets such as QRM, qualifying CRE, qualifying commercial mortgage loans and qualifying automobile loans appear to have been largely written with the practices and procedures of domestic industry participants in mind, with no exemption for transactions that comply with retention requirements in any relevant non-US jurisdiction, which may lead to non-US issuers avoiding the US market in selling ABS interests and leading US investors to have reduced investment opportunities to diversify their portfolios;

2. the failure to try to harmonize the requirements under the US rules with CRD 122a enables non-US securitizers to retain a significant arbitrage opportunity, that is unavailable to US securitizers, because CRD 122a permits unfunded risk retention and the Re-Proposal does not, further exacerbating the detrimental impact on US investor diversification opportunities described above; and

3. the elimination of the representative sample option for complying with the risk retention requirement rather than simplifying the methods for

compliance instead puts an additional disadvantage on US securitizers versus their non-US competitors.

IV. CONCLUSION

While generally a substantial improvement over the Original Proposal, the Re-Proposal still needs significant revision to be workable for many types of ABS. The Joint Regulators have requested comments on more than 100 specific aspects of the Re-Proposal, however, it is unclear how willing they will be to make changes that are necessary to preserve current securitization markets as there is substantial political pressure to finalize these (and other) rules that are required under the Dodd-Frank Act. Even though the Re-Proposal corrected a number of technical issues contained in the Original Proposal, it retained others and introduced new ones that will require correction or clarification before the rule is finalized.

ENDNOTES

1 Available at: http://www.mayerbrown.com/publications/Overview-of-the-Proposed-Credit-Risk-Retention-Rules-for-Securitizations-04-08-2011/.

2 Available at: http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20130828a1.pdf.

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