Federal Agencies Revise Proposed Securitization Risk Retention Rules

September 10, 2013

On August 28, 2013, five federal banking and housing agencies[1] and the Securities and Exchange Commission (collectively, the "Agencies") released a proposed rule implementing the credit risk retention requirement mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act for certain securitization transactions. The proposed rule revises and re-issues proposed rules originally issued by the Agencies on March 29, 2011.

Section 941 of Dodd-Frank added a new Section 15G to the Securities Exchange Act of 1934, which directs the Agencies to adopt rules that generally require sponsors of asset-backed securities to retain at least 5% of the credit risk relating to the assets that underlie such asset-backed securities. The risk retention requirement is intended to provide sponsors with a meaningful incentive to monitor and control the quality of securitized assets and align the interests of the sponsor with those of investors.

The proposed rule would apply the 5% risk retention requirement to most asset-backed securities, whether publicly or privately issued and regardless of the whether they are issued or sponsored by a regulated financial institution. However, the proposed rule would exempt certain asset-backed securities from the risk retention requirement. Chief among them are securities backed by "qualified residential mortgages"(sometimes referred to herein as "QRMs"), which are mortgages that lack certain product features that the Agencies cited as contributing to the high levels of mortgage delinquencies and foreclosures since 2007. Sponsors of securities backed by qualifying commercial loans, qualifying commercial real estate ("CRE") loans and qualifying automobile loans also will not be required to retain any credit risk. The criteria for the various "qualified" assets are intended to define assets that entail very little credit risk. Also, the proposed rule exempts loans guaranteed by the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"), for so long as these government-sponsored enterprises continue to operate under the conservatorship of the Federal Housing Finance Agency and have capital support from the United States.

The proposed rule makes several key revisions to the original proposal. Most importantly, it broadens the exemption for securitizations of qualified residential mortgages by adopting the definition of "qualified mortgage" adopted by the Consumer Financial Protection Bureau ("CFPB") pursuant to the Truth in Lending Act, as amended by Dodd-Frank. Unlike the

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[1] The five federal banking and housing agencies are the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Housing Finance Agency and the Department of Housing and Urban Development.

original definition of QRM, the new standard does not have a 20% down payment requirement, a loan-to-value ("LTV") ratio requirement or underwriting standards related to a borrower's credit history.

Other significant changes include:

- Combining the horizontal, vertical and L-shaped risk retention options (defined below) into one standard risk retention option, which allows for any combination of eligible horizontal and vertical interests;

- Changing the method of measuring risk retention in horizontal interests to fair value, as opposed to par value, and eliminating the premium cash capture reserve account requirement for sponsors issuing "interest only" tranches;

- Creating new risk retention options for open market collateralized loan obligations and municipal bond "repackaging" securitizations, and eliminating the "representative sample" option;

- Requiring third party special servicers of commercial mortgage-backed securities to be overseen by operating advisors in order to be eligible to meet the risk retention requirement in place of the sponsor;

- Introducing sunset provisions to allow sponsors to transfer or hedge retained interests after certain milestone dates; and

- Exempting from risk retention qualifying commercial loans, qualifying CRE loans and qualifying automobile loans even when pooled with non-qualifying assets.

This memorandum discusses these and other changes and provides an overview of the proposed rule. The proposed rule will be published shortly in the Federal Register and comments will be invited for 60 days. The proposal includes more than 100 questions on which the Agencies are seeking comment. The risk retention requirement will apply to asset-backed securities collateralized by residential mortgages issued one year after the effective date of the final risk retention rule, and to all other asset backed securities issued two years after the effective date of the final rule.

A. THE GENERAL 5% CREDIT RISK RETENTION REQUIREMENT

In adopting Section 15G of the Exchange Act, Congress sought to address certain aspects of the securitization process that it believed masked credit risks and complicated actions to mitigate losses and reduce loan defaults. In particular, Congress cited an "originate to distribute" model, in which loans were made for the purpose of selling them into securitization pools without the originator retaining any risk on the assets, as leading to lax credit and loan underwriting standards, as well as to practices that rewarded volume over asset quality. Congress identified such abuses in the securitization process as a "major contributing factor" to

the recent financial crisis,[2] and it adopted the credit risk retention requirement to better align the economic interests of securitizers with those of investors in asset-backed securities.

Under the proposed rule, a sponsor of "asset-backed securities" is generally required to retain at least 5% of the credit risk relating to the underlying assets (in addition to any other risk that may be retained to satisfy contractual requirements between the parties). The sponsor is generally not permitted to hedge or transfer the credit risk that it is required to retain. The term "sponsor" is defined to mean "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." The term "asset-backed security" is defined by incorporating the definition of that term in Section 3(a)(79) of the Exchange Act, where it is generally defined to mean "a fixed income or other security collateralized by any type of self-liquidating financial asset (including a loan, lease, mortgage, or other secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset."

B. ACCEPTABLE FORMS OF CREDIT RISK RETENTION

Sponsors may retain credit risk in a number of ways. The proposed rule is designed to be flexible in light of the heterogeneity of securitization markets and practices, the fact that different forms of risk retention may have different accounting implications for sponsors and the need to reduce the potential for any negative effect on the availability and cost of credit. Accordingly, sponsors can select from a "menu of options" to comply with the 5% risk requirement.

Among the acceptable forms of credit risk retention are the following:

- *Standard Risk Retention Option* – Under the standard option, a sponsor would have to retain an eligible vertical interest, an eligible horizontal residual interest, or any combination of the two, in a total amount of at least 5% of the fair value of all interests in the issuing entity. An eligible vertical interest is a vertical "slice" of each class or tranche of interests in a securitization transaction consisting of the same percentage of the fair value of each class. An eligible horizontal residual interest is a "first-loss" interest in the issuing entity that may not receive any payments of principal or interest until all other interests in the issuing entity are paid in full. The original proposal had also included an "L-shaped" risk retention option composed of specific proportions of vertical and horizontal interests. Under the standard risk retention option of the revised proposed rule, a combination of vertical and horizontal interests may consist of any proportion of each type of interest.

- *Revolving Master Trusts (Seller's Interest)*—In securitizations collateralized by assets held in a revolving master trust, such as credit card accounts or dealer floorplan loans, a sponsor typically retains a "seller's interest," which is a direct interest in the performance of the underlying assets or receivables that is pari passu to each series of investors' interests. Under the proposed rule, a sponsor of an asset-backed

2 *See* S. Rep. No. 111-176, at 128 (2010).

securities issuance collateralized by assets held in a master trust may satisfy the risk retention requirement by retaining directly or through an affiliate a seller's interest of at least 5% of the unpaid principal balance of all outstanding investors' interests issued by the issuing entity. The sponsor must meet this 5% test at the closing of every 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. Under the proposed rule, the sponsor may combine the seller's interest with a horizontal risk retention for purposes of meeting the 5% risk retention requirement by retaining a horizontal interest in every series issued by the trust and reducing its seller's interest by a corresponding percentage. This combination approach was not available under the original proposal. The proposed rule also offers relief to a sponsor that suffers a decline of its seller's interest below the 5% minimum due to an early amortization of investors' interests under the terms of the revolving trust securitization, provided that the sponsor had been in full compliance with the risk retention requirements before the early amortization event and the master trust issues no additional interests other than to the sponsor.

- *Asset-Backed Commercial Paper Conduits*—The proposed rule includes a special risk retention option for asset-backed commercial paper ("ABCP") conduits that issue short-term commercial paper and that satisfy certain requirements. This option contemplates a securitization structure in which originators of loans and receivables or their affiliates sell them to one or more intermediate special purpose vehicles (each, an "intermediate SPV") that are organized by the sponsor. The intermediate SPV then issues a senior interest in the loans and the receivables to the ABCP issuing entity and issues a residual interest to the originator-seller. The risk retention requirement would be satisfied if the originator-seller or an affiliate held this residual interest in the same form, amount, and manner as would be required under either the standard risk retention or revolving master trust options described above, including the respective 5% retention requirements. The ABCP conduit then issues short-term (nine months or less) ABCP that is collateralized by the senior interests. While an intermediate SPV may purchase assets from multiple originator-sellers, each senior interest sold by the intermediate SPV to the ABCP conduit must be backed solely by (A) asset-backed security interests collateralized solely by assets originated by a single originator-seller and its affiliates, and by servicing assets[3], (B) special interests in a trust or SPV that retains legal title to leased property underlying leases transferred to an intermediate SPV in connection with a securitization collateralized solely by such leases originated by a single originator-seller and its affiliates, and by servicing assets, or (C) interests in a revolving master trust collateralized solely by assets originated by a single originator seller and its affiliates,

[3] Servicing assets are any rights or other assets designed to assure the servicing, timely payment, or timely distribution of proceeds to security holders, or assets related to 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.

and by servicing assets. This option is not available for loans or receivables purchased by the originator-seller. The ABCP must have 100% liquidity coverage (in the form of a lending facility, an asset purchase agreement, a repurchase agreement or similar arrangement) from a regulated liquidity provider. Although this risk retention option would allow an originator-seller (rather than the sponsor) to retain the required 5% residual interest, the sponsor will be responsible for ensuring an originator-seller's compliance with all of the requirements of this option. For ABCP conduits that do not meet the requirements for this option, the sponsor will need to satisfy the 5% risk retention requirement.

- *Commercial Mortgage-Backed Securities*—In the market for commercial mortgage-backed securities ("CMBS") it is common for a third party which is not the sponsor to acquire a "first-loss" position in the form of a "B-piece." To manage its risk exposure, the B-piece buyer is involved in the selection of pool assets, performs diligence on those assets, and, as special servicer, services loans in default or having other non-payment issues. The CMBS risk retention option requires the special servicer role to be overseen by an independent operating advisor that, on behalf of the investors as a whole, has the ability to recommend replacement of the special servicer and, if the principal balance of the B-piece declines to 25% or less of its initial balance, has consultative rights over major decisions of the special servicer. The proposed rule would permit a sponsor of asset-backed securities that are collateralized solely by CRE loans and servicing assets to satisfy the risk retention requirement if: (i) the B-piece buyer retains a horizontal residual interest in the same form, amount and manner as would be required of the sponsor under the standard risk retention option (discussed above); (ii) the B-piece buyer pays for this first-loss position in cash at the closing of the securitization without financing; (iii) the B-piece buyer has performed a detailed review of the credit risk of each asset in the pool prior to the sale of the asset-back securities by examining, at a minimum, the underwriting standards, collateral and expected cash flows of each commercial loan in the pool; (iv) the B-piece buyer is not affiliated with any party to the securitization transaction other than the special servicer or investors; (v) the sponsor makes certain required disclosures to potential investors regarding the B-piece buyer (*e.g.*, identifying information, description of experience in CMBS transactions) and other material information on the transaction; and (vi) the B-piece buyer complies with the proposed rule's restrictions relating to the hedging of retained interests. The B-piece buyer may not transfer its interest for five years following closing. The proposed rule, unlike the original proposal, allows a B-piece buyer or sponsor that retains the B-piece to transfer its interest after five years to any other purchaser satisfying the criteria applicable to initial B-piece buyers, which may subsequently transfer its interest to any other eligible purchaser. Further, while the original proposal allowed only one B-piece buyer per CMBS transaction to satisfy the CMBS risk retention option, the proposed rule allows two B-piece buyers to share the retained risk, provided that each buyer's interest is pari passu with the other's interest and each buyer conducts an independent review of the credit risk of each asset in the pool.

- *Open Market Collateralized Loan Obligations*—The proposed rule adds a new risk retention option for certain CLOs. In prevailing market practice, some CLOs consist of commercial loans originated and syndicated by third parties that are selected for purchase on the open market by CLO managers unaffiliated with the originating and syndicating third parties and lacking the balance sheet capacity to fund 5% risk retention of the CLO. The proposed rule defines an "open market CLO" as a CLO the assets of which consist of less than 50% in aggregate principal amount of loans syndicated or originated by parties that are affiliates of the CLO. By contrast, a "balance sheet CLO" obtains a majority of its assets from the entity that controls the portfolio selection and, as the originator or syndicator of loans, has the balance sheet capacity to satisfy risk retention requirements. The Agencies recognized that imposing the standard risk retention option on open market CLO managers could cause significant disruption to the CLO market and consolidation among CLO managers. Accordingly, under the proposed rule, an open market CLO can satisfy the risk retention requirement if the lead arranger of each loan tranche purchased by the CLO retains at least 5% of the face amount of the loan tranche purchased by the CLO and takes an initial allocation of at least 20% of the face amount of the broader syndicated credit facility. The lead arranger must retain the 5% interest in the CLO-eligible tranche until the repayment, maturity, involuntary and unscheduled acceleration, payment default or bankruptcy default of the loan. However, the open market CLO would be free to sell its interest in the CLO-eligible tranche. Sponsors of balance sheet CLOs would still be subject to the standard risk retention option.

- *Municipal Bond "Repackaging" Securitizations (Tender Option Bonds)*—The proposed rule adds two risk retention options for certain municipal bond repackaging securitizations, also known as tender option bonds ("TOBs"). A TOB typically 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 known as the "floater," and an inverse floating rate security known as the "residual." Floaters, typically held by money market mutual funds, are short-term securities that are typically puttable at par on a daily or weekly basis. Highly rated institutions provide a liquidity facility to support this put right. Qualified TOBs eligible for the new risk retention options are those in which: (i) the collateral consists solely of municipal securities, as defined in Section 3(a)(29) of the Exchange Act, all of which have the same municipal issuer and obligor, and servicing assets, (ii) only two classes, floater and residual, are issued, (iii) holders of the floater may tender their interest to the issuer for purchase at any time upon no more than 30 days' notice, (iv) the floater qualifies for purchase by money market mutual funds under Rule 2a-7 of the Investment Company Act of 1940, (v) interest payments made on the floater, residual and underlying municipal security are all tax deductible to the owners of such securities, and (vi) the issuer has 100% liquidity coverage from a regulated liquidity provider. A sponsor of a qualified TOB may satisfy the risk retention rules in two ways, in addition to the any of the other risk retention options. First, the sponsor may hold municipal securities from the same issuance deposited in the qualified TOB, the face value of which is 5% of the face value of the municipal securities deposited in the qualified TOB. Second, the sponsor may retain an interest

that upon issuance meets the requirements of an eligible horizontal residual interest but upon the occurrence of certain events including bankruptcy, default or credit downgrade, will meet the requirements of an eligible vertical interest.

The proposed rule eliminates the "representative sample" option from the original proposal, which would have allowed a sponsor to retain a randomly selected representative sample of assets that is the equivalent in all material respects to the securitized assets.

Notably, the proposed rule changes the method of measuring the 5% retention requirements with respect to eligible horizontal interests by replacing par value in the original proposal with fair value as defined in GAAP. The use of par value in the horizontal risk retention option of the original proposal had been intended to provide a simple and transparent measure of calculation, but introduced other complexities. With the switch to fair value, the proposed rule also eliminated the "premium cash capture reserve account" requirement for sponsors issuing interest-only tranches.[4]

Consistent with the original proposal, the proposed rule would allow a sponsor that satisfies its risk retention requirement to allocate the retained risk to any originator of the securitized assets that contributed at least 20% of the underlying assets. An originator may not be allocated a greater portion of the risk than the percentage of the securitized assets that it contributed by the originator, and must be allocated horizontal and vertical interests in the same proportion as the sponsor. The sponsor will be responsible for the originator's compliance with, among other things, the prohibition on an originator hedging or transferring the risk it retains.

C. THE RESTRICTIONS ON HEDGING OR TRANSFERRING

As a general matter, a sponsor may not transfer any interest or assets that it is required to retain to any person other than an affiliate that majority controls, is majority controlled by, or is under common majority control with, the sponsor. As discussed above, the proposed rule creates an exception for B-piece interests in CMBS transferred to eligible purchasers after five years. A sponsor and its affiliates are also generally restricted from hedging the credit risk the sponsor is required to retain. The proposed rule creates a new "sunset" on the transfer and hedging restrictions. Retained interests of asset-backed securities other than residential mortgage backed securities ("RMBS") may be transferred or hedged after the latest of (i) the date on which the total unpaid principal balance of the collateral is reduced to 33% of the unpaid principal balance at closing, (ii) the date on which the unpaid principal balance of the interests issued in the securitization is reduced to 33% of the unpaid principal balance at closing, or (iii) two years after closing. Because residential mortgages typically have a longer duration than other assets and weaknesses in underwriting may take longer to manifest, retained interests in RMBS may be transferred or hedged after the later of (i) the date on which the unpaid principal

[4] The original proposal required sponsors to place funds in a premium capture cash reserve account when they sold interest-only tranches at the outset, in order to prevent sponsors from reducing the economic impact of risk retention by monetizing the excess spread that was expected to be generated over time and diminishing, over time, the value of the most subordinated tranche relative to par.

balance of the residential mortgage collateral is reduced to 25% of the unpaid principal balance at closing, or (ii) five years after closing.

Additionally, limited exceptions to the hedging restrictions exist for certain risks that are not materially related to the credit risk of the sponsor's retained interest or of the particular assets that underlie the securitization transaction. Permitted hedges include positions related to overall market interest rate movements; currency rates; or the overall value of a particular broad category or index of asset-backed securities (such as home prices), subject to limitations on the portion of the index that may be represented by the specific securitization transaction or applicable issuing entities. Hedges based on securities that are backed by similar assets originated and securitized by other sponsors also would be permitted. The proposed rule also restricts a sponsor and its affiliates from pledging as collateral for any obligation any interests or asset that the sponsor is required to retain, unless the obligation is with full recourse to the sponsor or consolidated affiliate.

Importantly, an originator, originator-seller or a third party purchaser that retains credit risk in accordance with the proposed rule must comply with these restrictions to the same extent as the sponsor.

D. THE EXEMPTION FOR "QUALIFIED RESIDENTIAL MORTGAGES"

Section 15G of the Exchange Act provides that a securitizer shall not be required to retain any part of the credit risk for an asset that is transferred or sold through the issuance of asset-backed securities by the securitizer if *all* of the assets that collateralize such securities are "qualified residential mortgages." Section 15G requires that the definition of a QRM be "no broader than" the definition of a qualified mortgage (sometimes referred to herein as a "QM") under Section 129C of the Truth in Lending Act, but otherwise left it to the Agencies to define what constitutes a qualified residential mortgage.

The proposed rule defines a qualified residential mortgage *as* a qualified mortgage as defined by the CFPB under the Truth in Lending Act.[5] Dodd-Frank amended the Truth in Lending Act to require originators of residential mortgages to make a reasonable and good faith determination, based on verified and documented information, that the borrower has a reasonable ability to repay the loan according to its terms. To meet this standard, Dodd-Frank establishes a rebuttable presumption and a safe harbor for loans that are qualified mortgages. The final QM rule is effective January 10, 2014.

Defining QRMs as QMs represents a significant departure from the original proposal, which provided a framework for assessing whether residential mortgage assets underlying a

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[5] *See* 78 Fed. Reg. 6407 (Jan. 30, 2013) as amended by 78 Fed. Reg. 35429 (June 12, 2013) and 78 Fed. Reg. 44686 (July 24, 2013). Dodd-Frank delegated initial rulemaking authority to define qualified mortgages to the Federal Reserve Board, and provided for a transfer of this authority to the Consumer Financial Protection Bureau on July 21, 2011. For more information regarding the CFPB's definition of qualified mortgage, please see our memorandum, dated January 29, 2013, available at http://www.stblaw.com/about-us/news/details?id=8d2e5d51-041b-40fd-a828-5f6bc23f5286.

securitization were of such quality that they merited a complete exemption from any risk retention requirement. This framework included relatively strict minimum underwriting standards with specific LTV ratios and a minimum 20% down-payment requirement, as well as disqualifying "derogatory factors" relating to borrowers. The CFPB's final QM rule, on the other hand, is concerned primarily with product features and a borrower's debt repayment capacity. The Agencies noted that of loans originated from 2005 to 2008 that met the QM criteria, 23% experienced a foreclosure or a delinquency of 90 days or more by the end of 2012, compared to 44% of loans that did not meet the QM criteria.

1. General Definition of Qualified Mortgages

The final QM rule provides several definitions of qualified mortgages, and the proposed rule allows a loan meeting any of these definitions to be a QRM. Below are the general requirements that must be met for a residential mortgage loan to be considered a "qualified mortgage":

- *Regular Payments*—The loan must have regular periodic payments that are substantially equal.
- *Elimination of Nontraditional Loan Features*—The loan generally cannot have features such as negative amortization (where the principal amount increases), interest-only payments (where a borrower only pays the interest for a specified period of time so the principal does not decrease with payments), or balloon payments (where the payment is more than two times a regular periodic payment).
- *Maximum Loan Term*—The loan cannot have a term exceeding 30 years.
- *Limits on Points and Fees*—If the loan is for $100,000 or more, it cannot have points or fees greater than 3% of the total loan amount. Stricter limits apply for smaller loans.
- *Income Verification and Monthly Debt-to-Income Ratio Cap*—Creditors must satisfy general underwriting criteria for the loan, including by verifying a potential borrower's current or reasonably expected income or assets (other than the value of the home securing the loan). The final QM rule also generally requires that monthly payments be calculated based on the highest payment that will apply in the first five years of the loan and that the borrower have a total "back-end" debt-to-income ratio no greater than 43%.

The final QM rule draws a distinction between higher-priced QMs, which receive a rebuttable presumption of compliance with the Truth in Lending Act, and QMs that are not higher-priced loans, which receive a legal safe harbor for compliance. For the purpose of the proposed risk retention rule, both higher-priced and non-higher-priced QMs are eligible as QRMs and can be pooled together in the same securitization.

2. Temporary Second Qualified Mortgage Definition

The final QM rule provides for an temporary second QM definition, which is similar to the general QM definition, but does not independently require for creditors to verify income nor require a specified debt-to-income ratio. Loans are eligible for this definition if they are eligible for purchase, guarantee or insurance by Fannie Mae, Freddie Mac, the Department of Housing and Urban Development (including the Federal Housing Administration, or FHA), the Veterans Administration, the U.S. Department of Agriculture or Rural Housing Service.

The temporary second definition will expire as to any loan eligible for purchase or guarantee by Fannie Mae or Freddie Mac once that institution exits conservatorship, and will expire as to any loan eligible to be insured or guaranteed by the FHA, the U.S. Department of Veteran Affairs, the U.S. Department of Agriculture, and the Rural Housing Service once the relevant agency issues its own QM rule.

3. Small Creditors

The final QM rule provides additional QM definitions for small creditors, *i.e.*, lenders originating 500 or fewer first-lien residential mortgage loans in the preceding calendar year with assets under $2 billion. For example, small creditors operating predominantly in rural or undeserved areas may originate balloon-payment loans, but these loans must have a term of at least five years, a fixed-interest rate, and meet certain basic underwriting standards. Other small creditors may originate balloon loans for a two year grace period. However, QMs under these definitions are required to be held by lenders for three years, and thus would not be eligible for securitization during that time.

4. Alternative Proposal

The Agencies are seeking comment on an alternative approach to defining QRMs. The alternative approach would begin with the CFPB's QM definition and add additional requirements: (i) a QRM must be secured by a one-to-four family property that constitutes the borrower's principal dwelling; (ii) a QRM must be a first-lien mortgage; (iii) the borrower's credit history must meet certain requirements; and (iv) the LTV ratio at closing cannot exceed 70%. While the Agencies did not select the alternative approach for the proposed rule, they provided data from several studies demonstrating that of QM-eligible loans originated in the years leading up to the recent financial crisis, those with an LTV ratio of 70% experienced significantly lower delinquency rates.

E. OTHER QUALIFIED ASSET CLASSES

In addition to the general exemption for qualified residential mortgages, the proposed rule provides special treatment for qualified loans in certain other asset classes. Asset-backed securities that are collateralized exclusively by qualifying commercial loans, qualifying CRE loans and qualifying automobile loans would not require risk retention. These qualifying loans would need to meet conservative underwriting standards that ensure they are of very low credit risk, which are more stringent than existing supervisory guidelines of the federal banking regulators. The underwriting standards applicable to these asset classes are summarized below.

- *Commercial Loan Asset Class*—The underwriting standards for commercial loans will require an originator to conduct an analysis of the borrower's ability to service all outstanding debt over the next two years and to determine that, following origination, the borrower will have a total liabilities to total tangible assets ratio of 50% or less, a leverage ratio of 3.0 or less and a debt service coverage ("DSC") ratio of no less than 1.5. The loan payment amount must be determined based on straight-line amortization of principal and interest over a term that does not exceed five years from origination, and the primary repayment source for the loan must consist of business revenue of the borrower. Loan documentation must include covenants that restrict the borrower's ability to incur additional debt or transfer or pledge its assets. There must also be financial reporting covenants, which provide a servicer with financial information on at least a quarterly basis.

- *CRE Loan Asset Class*—The underwriting standards for CRE loans focus principally on the borrower's ability to repay the loan (including a requirement that a borrower have a DSC ratio of at least 1.7 or greater or, in the case of certain types of properties with a demonstrated history of stable net operating income, 1.5 or greater or 1.25 or greater); the value of, and the originator's security interest in, the collateral; an LTV ratio of no more than 65% and combined LTV ratio of no more than 70%; and whether the applicable loan documentation includes appropriate collateral-protecting covenants.

- *Automobile Loan Asset Class*—The underwriting standards for automobile loans are generally comparable to industry standards for unsecured lending, focusing principally on the borrower's ability to repay the loan. At the time of origination, the borrower's debt-to-income ratio, including payments on the proposed loan, must be no greater than 36% and the borrower's credit history must be clear of any delinquency of 30 days or more within the past 30 days, as well as of any bankruptcy, foreclosure or similar proceeding within the previous 36 months. The borrower must also have 24 months of credit history, meet a 10% down payment requirement and will be prohibited from deferring principal or interest under the loan documents. These conservative underwriting standards are, in large measure, a reflection of the highly depreciable nature of the collateral involved in automobile loans.

The proposed rule, unlike the original proposal, exempts from risk retention qualifying assets (qualifying commercial loans, CRE loans and automobile loans) even when pooled with non-qualifying assets securing the same asset-backed security. A sponsor may reduce its 5% risk retention requirement by the ratio of the unpaid principal balance of qualified assets to the total unpaid principal balance of all assets in the pool, provided that the sponsor discloses to investors, its primary Federal regulator and the SEC the manner in which it determined its aggregate risk retention requirement. This treatment is not available for securitization of loans from different asset classes (*i.e.*, automobile and commercial) that secure the same asset-backed security.

F. TREATMENT OF GOVERNMENT-SPONSORED ENTERPRISES AND GOVERNMENT AGENCIES

For so long as Fannie Mae and Freddie Mac continue to operate under the conservatorship of the Federal Housing Finance Agency and have the benefit of the Senior Preferred Stock Purchase Agreement with the U.S. Treasury Department, the 100% guarantees they provide for mortgage-backed securities that they issue would be deemed to satisfy the risk retention requirement. This treatment is significant because these government-sponsored enterprises, together with other government agencies (most notably, the FHA and VA) whose guarantees will exempt a securitization transaction from the risk retention requirement (provided that such transaction is collateralized solely by loans guaranteed by such agencies), backstop approximately 90% of single-family conforming loans currently being issued in the residential mortgage loan market.

Finally, the proposed rule adds an exemption from the risk retention requirements for securitization transactions that are sponsored by the FDIC acting as conservator or receiver under any provision of the Federal Deposit Insurance Act or its Orderly Liquidation Authority under the Dodd-Frank Act.

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For more information about the proposed risk retention rule, please contact a member of Simpson Thacher's Financial Institutions Group.

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