Communication between Federal Reserve Staff
and Representatives of The American Securitization Forum (ASF)
July 11, 2011

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Summary: Representatives of ASF and staff of the Federal Reserve Board and the Federal Reserve Bank of New York participated in a telephonic discussion regarding the proposed rules to implement the requirements of section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Representatives of ASF provided a presentation of their overall views on the proposed risk retention rules. A copy of the handout provided by ASF for the discussion is attached below. The handout formed the basis for discussions and summarizes the issues discussed.

American SECURITIZATION FORUM®

ASF Financial Intermediary Discussion Points
Joint Regulator Risk Retention Proposals
Premium Capture Cash Reserve Account (PCCRA)
Meeting at Federal Reserve Bank of New York
July 11, 2011
4 PM ET

General Requirements

- If excess spread is monetized, the premium received must be placed into a separate "premium capture cash reserve account" ("PCCRA") to absorb losses first
    - Effectively adds onto the Dodd-Frank 5% risk retention requirement the entire value of ABS issued over par

- Funded amount would be the difference between (i) the gross proceeds from all sold ABS; and (ii) the *par value* of all issued ABS (not counting retention)
    - **Alternative View**. Some regulators believe the formula was meant to be based on *market value* and the sole purpose of the PCCRA is to ensure that the risk retained by the sponsor is worth at least 5% of the *market value* of issued ABS

- Example: $100 UPB pool, with $95 sold and $5 retained as first loss
    - Assume $102 proceeds, including $99 for sold ABS (104.21% * $95) and $3 for retained ABS (60% * $5)
    - Under the rule as written:
        - PCCRA = $99 - (95% * 100) = $99 - $95 = $4
    - Under the rule as interpreted by at least one regulator:
        - PCCRA = $99 - (95% * 102) = $99 - $96.90 = $2.10
        - Thus, market value of retained ABS + PCCRA = $5.10 retention (or 5% of MV of ABS

PCCRA Will Cause FAS 167 Consolidation & Trigger High Risk-Based Capital Requirements for Banks

- As written, PCCRA will likely result in balance sheet consolidation regardless of retention form employed
    - Adding PCCRA to vertical slice would cause consolidation in virtually all cases
    - Adding PCCRA to representative sample retention may also cause consolidation. As such, PCCRA, as drafted, may cause consolidation on its own, without any additional deal retention requirements

Immediate Effects of PCCRA

- As drafted, the PCCRA:
    - Eliminates upfront returns by sponsors
    - Because the PCCRA does not take into account the costs of origination, securitization may no longer be a competitive funding source for non-QRM loans
    - Interferes with ability to hedge interest rates and thus rate-lock borrowers
        - Cost of hedge cannot be recouped and any upside would be deposited in PCCRA
    - Unduly affects low to moderate income borrowers because higher interest rates result in more excess spread

Important Potential Unintended Consequences to Consider

- Given consolidation issues, a bank's inability to generate an upfront return or even recoup origination costs, is there any incentive for a bank to securitize non-QRM loans if PCCRA was implemented?

- PCCRA has been described as a way to make the economics of securitization the same as portfolio lending. Is that appropriate given the purpose of securitization? Wouldn't a bank choose a different funding option if portfolio lending was the goal? Or due to balance sheet constraints or return requirements, would banks simply lend less?

- PCCRA promotes a leveraged on-balance sheet portfolio model, which is the model generally used by REITs. Should the future of the private mortgage market include substantially larger reliance on REITS? What is the expected capacity of REITs to fund mortgages in the private market if the GSEs are scaled back?

- Would a substantial increase in reliance on REITS as a source of funding for residential mortgage credit be pro-cyclical or counter-cyclical? Do REIT investors have more or less information and sophistication to manage the risk of investing in the residential mortgage market than RMBS investors?

- Could the private-label RMBS market expand sufficiently to permit the role of the GSEs to be scaled back for non-QRM loans if the PCCRA proposal is implemented? If the role of the GSEs was scaled back at a time when the PCCRA was required, what would be the impact on the cost and availability of residential mortgage credit?

- Given that the PCCRA creates substantial disincentives for new non-GSE RMBS issuance, does it promote or discourage the objectives of scaling back the GSEs and stabilizing the residential housing market?

Risk Retention Proposed Rules

Accounting Consolidation, Premium Capture and ABCP Compliance

June 2011

Accounting Considerations

- **Vertical** – 5% of each tranche
  - Premium capture (discussed below) aside, accounting sale can be achieved even if issuer and servicer are affiliated
- **Horizontal** – 5% of par value of ABS; first loss position
  - Premium capture aside, accounting sale cannot be achieved if issuer and servicer are affiliated
- **L-Shaped** – 50/50 split of horizontal/vertical retention
  - Premium capture aside, accounting sale likely cannot be achieved if issuer and servicer are affiliated
- **Representative Sample**
  - Premium capture aside, accounting sale can be achieved even if issuer and servicer are affiliated
  - However, not likely to be used in its current form

Premium Capture Rule

- If excess spread is monetized, the premium received must be placed into a separate "premium capture cash reserve account" ("PCCRA") to absorb losses first
- Effectively adds onto the Dodd-Frank 5% risk retention requirement the entire value of ABS issued over par
- As drafted, the PCCRA:
  - Eliminates upfront returns by sponsors
  - Does not take into account the costs of origination
  - Interferes with ability to hedge interest rates and thus rate-lock borrowers
  - Unduly affects low to moderate income borrowers
- PCCRA will eliminate incentives for banks to securitize residential and commercial mortgages

Premium Capture Rule

- Premium Capture Formula
  - Funded amount would be the difference between (i) the gross proceeds from all sold ABS; and (ii) the *par value* of all issued ABS (not counting retention)
    - At least one regulator believes formula is based on *market value* and the sole purpose of the PCCRA is to ensure that the risk retained by the sponsor is worth at least 5% of the market value of issued ABS
  - **Example:** $100 UPB pool, with $95 sold and $5 retained as first loss
    - Assume $102 proceeds, including $99 for sold ABS (104.21% * $95) and $3 for retained ABS (60% * $5)
    - Under the rule as written:
      - PCCRA = $99 - (95% * 100) = $99 - $95 = $4
    - Under the rule as interpreted by at least one regulator:
      - PCCRA = $99 - (95% * 102) = $99 - $96.90 = $2.10
      - Thus, market value of retained ABS + PCCRA = $5.10 retention (or 5% of MV of ABS)

PCCRA Consolidation Issues

- As written, PCCRA may result in balance sheet consolidation regardless of retention form employed
  - Adding PCCRA to vertical slice would cause consolidation in virtually all cases
  - Adding PCCRA to representative sample retention may also cause consolidation – meaning, PCCRA could cause consolidation <u>on its own</u>
- However, if alternative interpretation was adopted, consolidation analysis of vertical slice retention would not be affected by PCCRA
  - Meaning, sale accounting could be achieved