BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: October 16, 2014

To: Board of Governors

From: Governor Tarullo DKT

Subject: Draft Risk Retention Notice of Proposed Rulemaking

Attached is a memorandum to the Board and a draft *Federal Register* a final rule implementing the securitization risk retention requirements of section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The final rule would be published jointly by the Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, the Federal Housing Finance Agency, and the Department of Housing and Urban Development in the *Federal Register* after all agencies have completed internal review and approval procedures.

The Committee on Bank Supervision has reviewed the rulemaking and I believe it is ready for the Board's consideration.

Attachment

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: October 16, 2014

To: Board of Governors

From: Staff[1]

Subject: Draft Final Credit Risk Retention Rule

ACTIONS REQUESTED: Staff seeks the Board's approval of the attached draft final rule (draft final rule) that would implement the credit risk retention requirements of section 15G of the Securities Exchange Act of 1934, as added by section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[2] The draft final rule would be issued jointly by the Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency (the Federal banking agencies), the Securities and Exchange Commission (SEC), the Federal Housing Finance Agency (FHFA), and the Department of Housing and Urban Development (HUD) (collectively, the agencies).

Staff also requests authority to make technical, non-substantive changes to the draft final rule in order to respond to comments from the *Federal Register* or to incorporate non-substantive changes requested by the other agencies as part of the approval process.

EXECUTIVE SUMMARY: Consistent with the statute, the draft final rule would require the sponsor of an asset-backed securities transaction to retain 5 percent of the credit risk with respect to an asset securitization transaction, unless a specific exemption under the rule applies.

- The draft final rule would become effective one year after the date on which it is published in the *Federal Register* for securitization transactions collateralized by residential mortgages,

---

[1] Mr. Alvarez, Mss. Snyder and Ahn, and Messrs. Knestout, Alexander, and Suntag (Legal Division); Messrs. Treacy, Boemio, Gabbai, and Healey (Division of Banking Supervision and Regulation); Ms. Pence (Division of Research and Statistics); and Ms. Pastor (Division of Consumer and Community Affairs).

[2] 15. U.S.C. 78o-11.

and two years after the date on which the final rule is published in the *Federal Register* for any other securitization transaction.

- The draft final rule would adopt the definition of "qualified residential mortgage" (QRM) as proposed in 2013, which aligns with the definition of "qualified mortgage" (QM) adopted by the Consumer Financial Protection Bureau (CFPB) in its ability-to-repay rules implemented pursuant to the Truth in Lending Act (TILA),[3] and provide a complete exemption from risk retention for securitizations of QRMs.
- The draft final rule includes a menu of options that would allow sponsors to choose how to meet their risk retention requirement. The menu of options includes "standard" risk retention (consisting of a residual "horizontal" residual interest, pro rata "vertical" interest, or a combination of the two) that could be used for any asset class, as well as options specific to certain asset classes (such as commercial real estate loan securitizations and asset-backed commercial paper transactions).
- The draft final rule is substantially similar to the rule proposed by the agencies in 2013 (the 2013 proposal).[4] The most significant changes include:
    - A commitment that the agencies would periodically review the QRM definition and its effect on the residential mortgage market, with the initial review occurring four years from the effective date of the rule;
    - Removal of the proposed restriction on cash flows to sponsors holding a horizontal risk retention interest (the so-called cash throttle, as discussed further below);
    - An exemption from risk retention for mortgages that are also exempted from the CFPB's ability-to-repay rules that are originated by institutions and organizations that focus on lower income and first-time borrowers;
    - Adjustments to the disclosures related to the fair value calculation required to measure horizontal risk retention; and
    - An exemption from risk retention for securitizations collateralized by owner-occupied mortgage loans that are secured by 3-4 unit residential properties that meet all the underwriting and product criteria for QM (qualifying 3-4 unit residential mortgage

[3] 15 U.S.C. 1639c.

[4] See 78 FR 57928 (September 20, 2013).

loans) and an exemption that allows securitizations collateralized by both qualifying 3-4 unit residential mortgage loans and QRMs.

- The draft final rule does not include a specific exemption for collateralized loan obligations (CLOs), which securitize leveraged loans, as requested by many commenters. However, the draft final rule would implement the option from the 2013 proposal for allocating risk retention to the lead arranger of leveraged loan syndications.
- The options under the draft final rule that would be available to particular types of asset classes include:
  - For commercial mortgage-backed securities (CMBS), an option to permit a sponsor's risk retention requirement to be satisfied if a third-party purchaser retains horizontal risk retention for at least five years;
  - For asset-backed commercial paper (ABCP) conduit transactions, an option to allow sponsors to rely on risk retained by originators of the assets securitized through the conduit structure;
  - For master trust securitizations, an option to allow sponsors to use a pro rata "seller's interest" (common in the credit card industry) and certain forms of overcollateralization to satisfy risk retention;
- Consistent with the 2013 proposal, the draft final rule would:
  - Exempt commercial loans, commercial real estate loans, and automobile loans from risk retention if they meet underwriting standards established in the draft final rule, with minor adjustments to the proposed standards for commercial real estate loans;
  - Limit the duration of the risk retention requirement; and
  - Deem the risk retention requirements of the Dodd-Frank Act to be met for securitizations guaranteed by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (the GSEs) as long as they operate under conservatorship or receivership of the FHFA with capital support from the United States.

BACKGROUND:

Congress enacted the risk retention requirements of section 15G of the Exchange Act to help address problems it perceived in the incentive structure of the securitization markets. Section 15G requires that securitizers, as a general matter, retain an economic interest in at least

5 percent of the credit risk of the assets they securitize in order to align the interests of the securitizer with the interests of investors, and to provide an incentive for sponsors to ensure that securitized assets meet underwriting and other standards to appropriately limit credit risk. Section 15G generally requires that the agencies jointly prescribe regulations under which securitization sponsors must retain not less than 5 percent of the credit risk of any asset that they securitize through the sale of asset-backed securities and prohibits a sponsor from hedging or transferring the risk it is required to retain. In addition, section 15G mandates that the agencies provide a complete exemption from risk retention requirements for securities collateralized solely by QRMs, as defined by the agencies in accordance with the requirements set forth in section 15G.[5]

In 2011, the agencies issued a proposal to implement the requirements of section 15G (the 2011 proposal).[6] The 2011 proposal included the menu of options for risk retention in the draft final rule, but measured horizontal risk retention using par value and a mechanism for capturing proceeds at the time of sale of the asset-backed securities in order to ensure meaningful risk retention. The proposed QRM definition from 2011 would have included underwriting standards such as a 20 percent down payment for purchase mortgage loans and a 70 or 75 percent maximum loan-to-value (LTV) ratio for mortgage refinances, as well as conservative credit history and debt-to-income requirements. The agencies received significant critical comment on the original proposal, most of which focused on the premium capture cash reserve account and on the proposed definition of QRM, which many comments asserted would significantly constrain access to mortgage credit. At the time of the 2011 proposal, the CFPB had not yet defined QM, which section 15G establishes as the outer bound for the definition of QRM.

The agencies developed and issued the 2013 proposal after considering comments on the 2011 proposal, as well as the final QM rule as adopted by the CFPB early in 2013. The 2013 proposal retained the basic structure of the 2011 proposal, but contained significant proposed

---

[5] In defining QRM, the agencies must consider underwriting and product features that historical loan performance data indicate result in a lower risk of default. QRM cannot be broader than the CFPB's definition of QM. See 15 U.S.C. 78o-11(e)(4).

[6] See 76 FR 24090 (April 29, 2011).

revisions. Having considered the state of the residential mortgage market, the contours of the QM definition and the ongoing market and regulatory reforms with respect to residential mortgages, the agencies proposed in 2013 to align the QRM definition with the CFPB's QM definition. Revisions to the 2011 proposal also included:

- More flexibility in the "menu of options" by permitting a sponsor to satisfy its risk retention obligation by retaining any combination of vertical and horizontal ownership interests;
- Measuring horizontal risk retention using fair value and requiring disclosures related to the calculation of fair value, including methodology and economic inputs and assumptions used in the calculation;;
- Removal of the premium capture provision from the 2011 proposal;
- Revision of restrictions on how quickly sponsors would be able to receive cash distributions with respect their horizontal risk retention interests (the cash throttle) so that the cash throttle would be tied to the fair value measurement;
- Limits on the duration of the prohibition on hedging and transfer of the sponsor's risk retention interest;
- An alternative to standard risk retention for CLOs, whereby certain CLO managers, as sponsors of CLOs, would not have to retain risk with respect to leveraged loans in the CLO if the lead arranger of the loan syndicate retained at least a 5 percent interest in the loan at origination (and did not later hedge or transfer the interest); and
- Modest changes to the underwriting standards for automobile loans, commercial mortgages, and commercial loans.

The Board received over 250 comment letters, including nearly 150 unique comment letters on the 2013 proposal. The majority of commenters supported the new proposed definition of QRM. A number of commenters criticized other aspects of the 2013 proposal, particularly the application of risk retention to CLOs, the cash throttle and disclosures related to the fair value calculation for horizontal risk retention, and the proposed underwriting standards for automobile loans, commercial mortgages, and commercial loans.

Staff has reviewed the comments on the 2013 proposal and is recommending some modifications to the proposed requirements to address commenter and other policy concerns raised in the 2013 proposal, as discussed further below, and as reflected in the draft final rule.

DISCUSSION:

The following discussion highlights key aspects of draft final rule, including modifications of the 2013 proposal. Additional discussions concerning each of these matters are in the identified pages of the attached draft final rule. Also attached as Appendix A is a high-level summary of comments received from the public in response to the 2013 proposal.

A. Scope

Consistent with the 2013 proposal, the draft final rule generally applies the statutory 5 percent risk retention requirements to a sponsor of a securitization transaction involving the sale of asset-backed securities. Section 15G of the Exchange Act stipulates that the risk retention requirements be applied to a "securitizer" of an asset-backed security, which is defined by the statute to include an issuer of an asset-backed security, as well as a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate or issuer. The attached draft final rule adopts this definition (See pp. 29-35). Commenters generally supported this approach except in the context of collateralized loan obligations, as discussed in more detail below.

B. Overview of the Risk Retention Requirements and Exceptions

Consistent with section 15G of the Exchange Act, the draft final rule would require that a sponsor retain an economic interest equal to at least 5 percent of the aggregate credit risk of the assets collateralizing an issuance of asset-backed security (ABS) interests in accordance with the methods for risk retention provided in the rule, unless an exemption applied.

1. Residential Mortgage Exceptions

a. Qualified Residential Mortgages

As noted above, under the statute, residential mortgages that the agencies define as qualifying residential mortgages have a complete exemption from risk retention requirements. By statute, the QRM definition cannot be broader than the definition for QM as implemented by the CFPB.[7] After weighing concerns about credit risk, mortgage credit availability and the

---

[7] 15 U.S.C. § 78o-11(e)(4)(C). QM is defined under section 129C(b)(2) of TILA (15 U.S.C. § 1639C(b)(2)), as amended by the Dodd-Frank Act, and regulations adopted thereunder by the

impact of new regulations on the mortgage market, the agencies proposed in 2013 to align the QRM with the QM definition as established by the CFPB.[8] The agencies also invited comment on a more conservative alternative approach to QRM that would include a 70 percent loan-to-value requirement and certain credit history standards as well as the QM standards. Most commenters supported the proposed alignment of QRM with QM. The few commenters that opposed the proposed definition did not support the alternative, more conservative approach and instead advocated that the agencies revert to the QRM definition in the 2011 proposal, which would have included underwriting standards such as a 20 percent down payment requirement for purchase mortgage loans, a 70 or 75 percent maximum loan-to-value requirement for mortgage refinance loans, and conservative credit history standards.

Staff recommends that the Board adopt the proposal to align QRM with QM. The QM definition excludes many loans with riskier product features, such as negative amortization, and requires, among other things, full documentation and verification of a borrower's debt and income. The QM definition also requires that borrowers meet a total debt-to-income threshold of 43 percent or less. This definition helps to lower the risk of default, and also helps to preserve access to affordable credit, especially for low-to-moderate income, minority or first-time homebuyers. The alignment of QRM with QM should also help facilitate the return of private capital to the mortgage market because it would limit bifurcation in the mortgage market between QRM and non-QRM loans and make available a large number of mortgages for securitization that are not subject to risk retention requirements. The QM standards, which must be implemented across the residential mortgage market, are also known to investors and should aid them in evaluating the credit quality of QRM pools. At the same time, aligning the QRM with the QM at this time will allow the agencies to observe developments in the residential mortgage market as it continues to recover following the crisis and determine whether adjustments to the QRM are warranted. (See pp. 355-360.)

Similarly, staff recommends that the Board adopt a provision added to the draft final rule that would commit the agencies to a periodic review of the QRM definition (as well as the other

---

CFPB. See 78 FR 6408 (January 30, 2013), as amended by 78 FR 35430 (June 12, 2013) and 78 FR 44686 (July 24, 2013).

[8] See 78 FR 57928, 57991-57993 (September 20, 2013).

residential mortgage exemptions discussed below) and its effect on the residential mortgage market, and sets forth parameters for the process of the review. The initial review would occur four years from the effective date of the rule (approximately five years from issuance) and then every five years thereafter. Any of the agencies may also at any time request to commence the review. The agencies would use these reviews to consider new developments in the housing and mortgage markets and whether changes to the QRM are warranted. The agencies would also consider the results of future reviews of, and any changes made to, the QM definition by the CFPB. (See pp. 360-363).

b. Exemptions for Qualifying 3-4 Unit Residential Mortgage Loans

Under Regulation Z, which implements the provisions that govern the QM definition, and accompanying official interpretations, mortgage loans extended to acquire owner-occupied 3-4 unit residential properties appear not to qualify for QM status even if they otherwise meet all of the other QM criteria.[9] Consequently, these loans would not be QRMs under the draft final rule.

In the securitization markets, mortgage loans collateralized by one-to-four unit properties are typically categorized as residential mortgages and mortgages of three-to-four unit properties are frequently combined in a single collateral pool with one- or two-unit residential properties. From a credit risk perspective, mortgages secured by 3-4 unit residential properties generally have the same characteristics as mortgages secured by two-unit properties, which are covered transactions under Regulation Z and may qualify as QMs, and, therefore, as QRMs.

The apparent exclusion of these loans from the definition of "covered transaction" under Regulation Z, and the consequence that they are not QRMs, even if they otherwise meet all of the other QM criteria, could inappropriately constrain funding from the securitization markets for these types of residential mortgages. Staff is therefore recommending that the agencies invoke the authority in the statute to provide an exception in the draft final rule for those owner-occupied mortgage loans secured by 3-4 unit residential properties where they meet all the criteria for QM in Regulation Z, but are not "covered transactions" for purposes of the QM definition (qualifying 3-4 unit residential mortgage loans). Furthermore, in order to ensure that

[9] See 12 CFR part 1026 Supplement I, paragraph 3(a)(5)(i). These loans appear not to be "covered transactions" under Regulation Z and its Official Interpretations because they are deemed to be extended for a business, rather than consumer, purpose.

qualifying 3-4 unit residential mortgage loans benefit from the exemption from risk retention as intended and maintain access to securitization markets and mortgage credit similar to residential mortgages that are QRMs, staff also recommends that the agencies draft an exemption in the draft final rule permitting sponsors to combine both QRMs and qualifying 3-to-4 unit residential mortgage loans in a single transaction.

Under section 15G(e) of the Exchange Act, the agencies may provide exemptions for risk retention if the exemption would help ensure high-quality underwriting standards for securitized assets and improve access of consumers to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors. As discussed in the draft final rule, staff believes these findings are met for the exemptions for qualifying 3-to-4 unit residential loans. (See pp. 392-398).

c. Exemption for Community-Focused Mortgage Loans

The agencies did not propose in 2013 to exempt from risk retention community-focused mortgage loans exempted by the CFPB from the ability-to-repay rules under TILA. Those loans exempted from ability-to-repay rules include: credit extended pursuant to a program administered by state housing finance agencies; credit extended by creditors designated by the U.S. Department of the Treasury as Community Development Financial Institutions; creditors designated by HUD as a Community Housing Development Organization that have entered into a commitment with a participating jurisdiction and are undertaking a project under the HOME program; creditors designated by HUD as a Downpayment Assistance through Secondary Financing Providers, and certain nonprofit creditors that meet the CFPB's requirements for the exemption.

Although only some of these categories of loans have been securitized, a number of commenters requested that the agencies exempt these loans from risk retention to ensure that these loans would continue to be eligible for securitization without potential increase in costs due to risk retention. These commenters argued that these loans are important to ensuring that low-to-moderate income and first-time borrowers obtain access to credit, and that the community focus of these lending programs, including their tailored underwriting process, would ensure sound underwriting.

In light of these comments, and in recognition of the role that these loans play in ensuring access to mortgage credit in many low-to-moderate income communities, staff recommends that the Board exempt the above referenced loans from risk retention. As discussed in the draft final rule, staff believes the findings required for this exemption under section 15G(e) are met with respect to the community-focused loans described above. (See pp. 378-392.)

2. Menu of Options

a. Standard Risk Retention

Consistent with the 2013 proposal, the final rule would allow a sponsor to retain risk in the form of a vertical interest (an interest in each class of the ABS interests in the transaction, or a single security representing a pro rata interest in the entire transaction) that meets the rule's eligibility criteria (eligible vertical interest), a horizontal residual interest (the most subordinated ABS interest) that meets the rule's eligibility criteria (eligible horizontal interest),[10] or any combination of the two. The risk retention requirement would be met if the percentage of the eligible vertical interest when added to the percentage of the eligible horizontal residual interest equals no less than five, and would be determined as of the closing date of the securitization transaction.

As noted above, the agencies proposed in 2013 generally to require sponsors to measure their risk retention requirement using fair valuation methodologies acceptable under GAAP.[11] Using fair value would ensure that the horizontal risk retention would be economically meaningful and measured using accepted methodologies understood in the market, facilitating the ability to compare risk retention across transactions. The fair value method also takes into account various economic factors that may affect a securitization transaction, which should aid investors in assessing the degree to which a sponsor is exposed to the risk of the securitized assets.

The requirements for the fair value measurement of risk retention under the draft final rule would be substantially similar to those in the 2013 proposal. Under the draft final rule, fair

---

[10] See section 2 of the draft final rule (definition of "eligible horizontal residual interest"). In lieu of holding all or part of its risk retention in the form of an eligible horizontal residual interest, the draft final rule would allow a sponsor to cause to be established and funded, in cash, an eligible horizontal cash reserve account, at closing, in an amount equal to the same dollar amount (or corresponding amount in the foreign currency in which the ABS interests are issued, as applicable) as would be required if the sponsor held an eligible horizontal residual interest.

[11] Cf. Financial Accounting Standards Board, Accounting Standards Codification Topic 820 – Fair Value Measurement.

value would be calculated using the fair value measurement framework under GAAP. In response to comments and to facilitate current market practice, the draft final rule makes some adjustments to the proposed requirements by allowing sponsors to calculate fair value as of a “cut-off” date (generally the date as of which the composition and characteristics of the collateral pool are stablished).

In the 2013 proposal, sponsors would have been required to disclose their fair value methodology and all significant inputs used to measure its eligible horizontal residual interest a reasonable time prior to the sale of the ABS. Sponsors also would have been required to disclose the reference data set or other historical information used to develop the key inputs and assumptions. Commenters raised a number of concerns regarding the proposed disclosure requirements. Some commenters expressed concerns that the rule would require them to disclose information that is proprietary ad highly confidential that could be used by third parties to the competitive disadvantage of a sponsor. Commenters also raised concerns regarding potential liability and litigation if fair value projections, assumptions and calculations disclosed to investors pursuant to the rule prior to sale of the ABS turned out to be incorrect. Some commenters asked for clarification regarding the required timing of the disclosures.

Staff believes that that it is important to the functioning of the markets and to fulfillment of the purposes of section 15G that the draft final rule ensure that investors and the markets, as well as regulators, are provided with key information about the methodology and assumptions used by sponsors to determine their risk retention requirement when holding an eligible horizontal residual interest. As the agencies have previously observed, fair value is a measurement framework that, for certain types of instruments, requires an extensive use of judgment. In situations where significant unobservable inputs are used to determine fair value, disclosures of those assumptions are necessary to enable investors to effectively evaluate the fair value calculation.

Therefore, staff recommends generally retaining the proposed fair value disclosure requirements with some modifications in response to commenter concerns. Under the draft final rule, sponsors would generally be allowed to describe their expected calculation methodologies and ranges of inputs and assumptions (based on bona fide estimates) used for disclosures prior to the sale of the ABS, and after sale any material differences between the expected methodologies, ranges of inputs and assumptions and those actually used in the fair value calculation. These modifications should effectively balance the benefits investors and others receive from the disclosures against the concerns raised by commenters. (See pp. 64-83).

As noted above, the 2013 proposal also contained cash throttle provisions that would have restricted how quickly a sponsor holding an eligible horizontal interest could receive distributions with respect to that interest. These restrictions were intended to ensure that the sponsor's economic exposure to the transaction was not reduced too quickly. Commenters expressed significant concern regarding the proposed cash throttle. Specifically, commenters argued that the proposed restriction was incompatible with a variety of securitization structures, including those that pay monthly cash flows predominantly from interest payments for much of the life of the securitization. Commenters argued that the re-proposal's failure to distinguish between payments of interest on the eligible horizontal residual interest and other ABS interests from payments of principal on those same interests would be largely unworkable with such transactions. In addition, commenters argued that it would be impossible to make the required projections of future cash flow for revolving structures, since their asset pools frequently change.

The draft final rule would not implement the proposed cash flow restriction or any similar alternative mechanism. Staff has considered the comments and commenters' alternative suggestions and has not been able to identify a cash flow restriction that would operate without significant risk of unintended consequences and undue disruption to various securitization markets, while functioning effectively across asset classes. In addition, staff believes that a cash flow restriction is not necessary to ensure meaningful risk retention, since the draft final rule includes a number of mechanisms, including rigorous disclosure requirements and restrictions on the ability to hedge or transfer a sponsor's credit risk, that achieve similar purposes. (See pp. 83-91.)

b. <u>Collateralized Loan Obligations</u>

A CLO is an asset-backed security that is collateralized by loans and a small amount of other assets. Often, CLOs are collateralized by portions of tranches of senior, secured commercial loans of lower credit quality, non-investment grade borrowers. There are two general types of CLOs: balance sheet CLOs that securitize loans held by a sponsor institution or its affiliates in portfolio, and "open market" CLOs that securitize assets purchased on the secondary market at the direction of a CLO manager that is not typically affiliated with the originators of the loans.

The 2011 proposal identified CLO managers as securitizers of CLO transactions that they managed for purposes of the risk retention requirements, and would have required them to retain risk on the same basis as any other sponsor. A number of commenters opposed this approach, arguing that open market CLO managers should not be required to (and financially could not afford to) retain risk in a CLO.

To provide more flexibility in achieving meaningful risk retention for CLOs, the agencies included in the 2013 proposal an option that would allow open market CLO sponsors to satisfy the risk retention requirement where the lead arranger for each syndicated loan purchased by the CLO retained, at the origination of the syndicated loan, at least 5 percent of the face amount of the term loan tranche purchased by the CLO (lead arranger option). The lead arrangers would be required to retain this interest until the loan prepaid, matured or experienced a payment or bankruptcy default or acceleration.

A number of commenters on the 2013 proposal raised significant concerns about, and objections to, the provisions in the 2013 proposal applicable to open market CLOs. These commenters argued that, because open market CLO managers typically do not own or acquire the loans that comprise the CLO's collateral pool, they do not meet the definition of "securitizer" under section 15G of the Exchange Act and therefore are not subject to risk retention requirements under the statute. In addition, commenters argued that the lead arranger option was unworkable given current market practice and would not be a meaningful alternative. Commenters argued that few open market CLO managers would have the balance sheet capacity to finance a risk retention requirement, with the result that a risk retention requirement would reduce CLO offerings and limit access to credit for commercial borrowers. Several commenters argued that open market CLOs should be exempted from risk retention or receive more favorable treatment because their structural characteristics (in particular their fee structure) already ensure investor protection and high underwriting standards.

The draft final rule would apply risk retention to CLOs substantially as proposed in 2013. As discussed further in the draft final rule, staff believes that CLO managers meet the statutory definition of "securitizer" in section 15G of the Exchange Act because they are persons that organize and initiate an asset-backed securities transaction by indirectly transferring assets to the issuer. Through its authority to identify assets and direct the issuer to purchase those assets, the CLO manager organizes and initiates the asset-backed securities transaction by typically negotiating the primary deal terms of the transaction and directing the CLO issuing entity to acquire the commercial loans that comprise the collateral pool. The CLO manager has sole authority to select the commercial loans to be purchased by the issuing entity and directs the issuing entity to purchase such assets.[12]

Staff does not recommend adopting a structural exemption from the risk retention requirements as suggested by commenters. There is significant evidence of widespread deterioration in underwriting standards for leveraged loans in recent years, which are the primary assets purchased by most CLOs. Further, many of the structural features that commenters cited in support of their arguments (such as the subordination of some of CLO managers' fees and participation by key investors in the negotiation of CLOs' investment guidelines) were shared by CDOs of ABS and other types of CDOs that performed poorly during the financial crisis. Requiring open market CLO managers or lead arrangers to retain economic exposure in the assets being securitized should help ensure the quality of assets purchased by CLOs, create discipline in the underwriting standards, and reduce risks that such loans may pose to financial stability. While the rules may cause a reduction in CLO issuance and have a modest impact on availability of commercial credit, staff believes that lending to creditworthy commercial borrowers will continue at a healthy rate and that the benefits of the rules outweigh projected impacts on the CLO and leveraged loan market.

In addition, despite commenter assertions that the lead arranger option will not be widely adopted by lead arranger banks, staff believes the option provides additional flexibility for lead arranger banks and non-banks and therefore may reduce disruption to the market. Further, the option should meaningfully align incentives of the party most involved with the credit quality of the securitized assets (the lead arranger) with the interests of investors. (See pp. 199-236.)

c. Master Trusts (Revolving Pool Securitizations)

Master trusts typically issue multiple series of asset-backed securities over time, collateralized by a common pool of securitized assets. They are the common vehicle for securitizing credit card receivables and assets with similar characteristics. The 2013 proposal would have recognized the "seller's interest" retained by a master trust sponsor as an acceptable form of risk retention to meet the sponsor's obligations under the rule.

---

[12] See memo from the Legal Division dated October 16, 2014 in the Office of the Secretary.

Staff recommends that the Board adopt in the draft final rule the proposed master trust option, with several refinements responding to commenter concerns and designed to expand the availability of the seller's interest option more broadly. The refinements would liberalize the structural elements of the seller's trust option by permitting any entity capable of issuing one or more series of ABS collateralized by a revolving pool to use the seller's interest option. The draft final rule would also revise the calculation of seller's interest to include both pari passu and subordinated interests, such as trust-wide overcollateralization and series-level junior bonds. (See pp. 91-135.)

d. Asset-Backed Commercial Paper

The 2013 proposal included an option designed specifically for sponsors of ABCP conduits, which issue commercial paper that may be collateralized by a wide range of assets including securitized automobile loans, commercial loans, trade receivables, credit card receivables, student loans, and other loans.

The draft final rule requirements for ABCP conduits are consistent with the 2013 proposal, with some modifications that respond to commenter concerns. The draft final rule would clarify that either an originator-seller of the securitized assets or its majority-owned affiliate may satisfy the risk retention requirement; clarify that a conduit must have one investor-facing liquidity facility provider (but permit the liquidity facility to be syndicated to additional providers); extend (to 397 days) the maximum allowable tenor of commercial paper issued by an 'eligible' conduit; expand the collateral criteria; and liberalize the definition for qualifying special purpose entities that are the vehicle for risk retention under the option. The draft final rule would not "grandfather" assets or ABS interests held by existing ABCP conduits as some commenters requested, consistent with other provisions in the rule. Section 15G of the Exchange Act applies to any issuance of asset-backed securities after the effective date of the rules, regardless of the date the assets in the securitization were originated. Section 15G and the draft final rule would not, however, apply to any securitization transaction conducted before the effective date of the final rule, which is one year after publication in the *Federal Register* with respect to securitizations of residential mortgages and two years after publication with respect to securitizations of other assets. (See pp. 140-170.)

e. Commercial Mortgage-Backed Securities

As contemplated by section 15G of the Exchange Act, the 2013 proposal included provisions that would permit third-party purchasers that act as special servicers to hold risk retention in lieu of the sponsor in CMBS transactions. The draft final rule would adopt these provisions substantially as proposed, with a few adjustments in response to specific comments. Consistent with the proposal, the CMBS option would allow a sponsor to satisfy the risk retention obligation if a third-party purchases a first-loss subordinated interest in the transaction, retains the interest for a minimum of 5 years in compliance with the rule's hedging and transfer restrictions, and meets certain other restrictions with respect to that interest. The rule would allow multiple third-party purchasers to combine to satisfy this risk retention option, but would require them to hold their interests in equal proportions and at the same level of subordination. In addition, in response to comment, the draft final rule would adjust the quorum needed for investors to vote to remove and replace the special servicer in order to ensure that an appropriate level of investor interest in the question of removal and replacement would be necessary for the vote to be operational. (See pp. 170-194.)

f. <u>Government-Sponsored Enterprises</u>

The 2013 proposal did not require additional risk retention for securitizations sponsored by GSEs while they are in conservatorship or receivership and receive financial support from the U.S. government. The GSEs fully guarantee the timely payment of principal and interest on the securities they issue and are exposed to the entire credit risk of the assets that collateralize those securities. In light of the authority and oversight that the FHFA has over the GSEs and the financial support that they are receiving from the U.S. government, staff continues to believe that it is appropriate to recognize the guarantee of the GSEs as fulfilling their risk retention requirement. In this regard, the draft final rule would adopt this section of the 2013 proposal without any changes. However, given the ongoing activity regarding reform of the GSEs, the draft final rule notes that treatment of the GSEs under the risk retention rules would be revisited once they are subject to reform. (See pp. 194-199.)

g. <u>Foreign Safe Harbor</u>

The draft final rule includes a "safe harbor" provision for certain securitization transactions with limited connections to the United States and U.S. investors, that is identical to the provision included in the 2013 proposal. The safe harbor effectively exempts the securitization from risk retention requirements. An important requirement of the safe harbor is that no more than 10 percent of the value of all classes of interests in the securitization transaction could be sold or transferred to U.S. persons.. Some commenters requested an expansion of this safe harbor so that securitization transactions with a larger percentage of securities sold to U.S. persons could also qualify. Other commenters requested that the agencies deem compliance with foreign risk retention regulations to be sufficient to comply with the risk retention requirements under the draft final rule. Staff does not recommend that the Board expand the safe harbor in order to ensure that the draft final rule would be applied to transactions with a significant connection to the United States. In addition, staff does not recommend recognizing compliance with foreign regulations as meeting the risk retention requirement under the draft final rule, because foreign risk retention regimes vary, many jurisdictions do not have risk retention requirements, and it would be difficult for the agencies to assess the meaningfulness of risk retention across securitization transactions under such a regime. (See pp. 271-277.)

3. Underwriting Standards and Exemptions for Automobile, Commercial Real Estate, and Commercial Loans

As contemplated by section 15G of the Exchange Act, the draft final rule would exempt from the risk retention requirements securitizations of various types of assets that meet minimum underwriting standards. Separate underwriting standards were set for commercial, commercial real estate, and auto loans. The underwriting standards in the draft final rule are similar to those in both the 2011 and 2013 proposals and include provisions related to (1) the borrower's credit history and ability to repay the loan, (2) valuation of the collateral, (3) loan-to-value ratios, and (4) risk management and monitoring.

The underwriting standards for qualifying loans in the draft final rule reflect supervisory experience with lending practices across diverse portfolios. The standards would be significantly tougher than the equivalent for QRM, as observed by some commenters. This difference in scope reflects the variability in these markets and underwriting practices, as well as the statutory requirement that the underwriting standards for exempting non-QRM assets indicate low credit risk.[13] In addition, policy considerations run against incorporating common underwriting

[13] 15 U.S.C. 78o-11(c)(2)(B).

practices that might allow more loans to qualify into the underwriting standards, such as credit scores developed by private, third-party vendors.

The Board received a number of comments on specific aspects of the underwriting standards for qualifying loans, particularly with regard to commercial real estate loans. In response to comments, staff is recommending minor adjustments to the commercial real estate underwriting standards. However, staff is not recommending the more significant changes commenters requested for commercial real estate loans, which included loosening debt service coverage ratio and LTV requirements, longer amortization periods, and longer minimum term requirements. Loosening these requirements would not be consistent with developing low credit risk across the commercial real estate industry.

Some commenters also requested that the agencies provide an additional qualifying commercial real estate exemption for single-borrower or single-credit transactions involving a securitization of cross-collateralized loans to one or more related borrowers, with more liberal underwriting standards to qualify for the exemption than the standards required to exempt other qualifying commercial real estate loans. Staff does not believe it would be feasible to construct more liberal underwriting standards for single-borrower and single-credit transactions to both address commenters concerns while appropriately limiting an exemption from risk retention commercial mortgages with low risk. In particular, staff is concerned that a single-borrower/single-credit category that benefitted from such an exemption would be prone to regulatory arbitrage that is difficult to monitor. Therefore, staff is not recommending an additional exemption for single-borrower or single-credit transactions in the draft final rule.

Consistent with the 2013 proposal, the draft final rule would allow sponsors to reduce their risk retention requirement for a securitized pool consisting of both qualifying and non-qualifying loans of a single asset class by the amount of qualifying loans included in the pool (blended pools). However, the risk retention requirement could not be reduced by more than 50 percent, so that the sponsor would always be required to meet at least a 2.5 percent risk retention requirement for blended pools. Some commenters requested that the agencies relax the 2.5 percent “floor” for blended pools, while others requested that the agencies maintain it. Other commenters requested that the agencies not permit blending in the final rule because of concerns that investors may have trouble evaluating the credit quality of non-qualifying assets in blended pools. Having considered the competing policy issues raised by commenters and the narrow scope of the underwriting requirements for qualifying loans, staff recommends that the Board adopt the blended pool limit as proposed to facilitate market liquidity for both qualifying and non-qualifying assets. The 2.5 percent "floor" would serve as a minimum risk retention requirement so that the economic incentive for the sponsor to ensure that the non-qualifying loans in the pool are appropriately underwritten is not unduly weakened. (See pp. 307-344.)

4. Hedging, Transfer, and Financing Restrictions

Under section 15G of the Exchange Act, a securitizer is prohibited from directly or indirectly hedging or otherwise transferring its risk retention interest. Accordingly, consistent with the 2013 proposal, the draft final rule would prohibit a sponsor or any of its affiliates from hedging the credit risk the sponsor is required to retain under the rule through any instrument or transaction that would reduce its credit risk exposure through the risk retention. The hedging restrictions would not prohibit a sponsor from benefiting from credit enhancements or risk mitigation products that are designed to benefit all investors, such as private mortgage insurance. (See pp. 264-271.)

The draft final rule would adopt the provisions in the 2013 proposal that limit the duration of the prohibition on hedging and transfer of the sponsor's risk retention interest, so that transfer or hedging may occur after the end of the period when default on the underlying assets is most likely to be associated with low quality underwriting. Commenters generally supported these provisions in the 2013 proposal. For CMBS, a sponsor (or the initial third party as applicable) could transfer the interest to another qualified third-party purchaser five years after the closing of the securitization transaction. For residential mortgage securitizations, the prohibition would end on the date that is the later of (1) five years after the closing of the securitization transaction or (2) the date on which the total unpaid principal balance of the residential mortgages is reduced to 25 percent of the original unpaid principal balance, in any case, not to exceed seven years from the date of the closing. For all other securitizations, the prohibition would end the later of (1) two years after the closing of the securitization transaction; (2) the date on which the unpaid principal balance of the securitized assets is reduced to 33 percent of the original balance; or (3) the date the total unpaid principal obligation of the securities issued is reduced to 33 percent of the original principal amount.

In addition, as proposed, the draft final rule would allow sponsors to securitize seasoned loans that are current and that have been outstanding for a period mirroring the sunset date for the loan's asset class, as described above. (See pp. 277-281; 292-294.)

5. Other Exemptions

The draft final rule would adopt, without material change, the exemptions from the risk retention requirements for government-backed securities, government-insured securitized assets, and pass-through resecuritizations from the 2013 proposal. These exemptions were either required by section 15G of the Exchange Act or proposed to be adopted using the agencies' general authority to exempt securitizations under the statute, if certain findings are made. Where applicable, the required findings are discussed in the preamble to the draft final rule. (See pp. 282-303.)

CONCLUSION: For the reasons discussed above, staff recommends that the Board approve the attached draft final rule. Staff also recommends that the Board delegate to staff the authority to make technical and minor changes to the attached materials prior to publication in the *Federal Register*, including responding to comments from the *Federal Register*, or to incorporate changes requested by other agencies as part of the approval process.

Overview of Comments on the NPR

The Board received approximately 250 comments, including nearly 150 unique comment letters, on the NPR. Commenters included banking organizations, trade associations, consumer advocacy groups, public officials (including members of the U.S. Congress), private individuals, and other interested parties.

General comments:

While most commenters supported the reproposed risk retention rule, many commenters expressed concerns about various aspects of the proposal. A substantial number of commenters requested significant revisions to the proposal, discussed below.

General Risk Retention Requirement:

Several commenters supported higher minimum risk retention requirements. Some commenters requested that the minimum requirement vary based on factors such as asset quality. Most commenters supported the menu of options for satisfying the risk retention requirement, but requested increased flexibility and additional options, including insurance policies, guarantees, liquidity facilities, and standby letters of credit. Commenters also requested specific modifications to various aspects of each option, discussed below.

Standard Risk Retention:

While several commenters expressed support for the use of fair value in measuring the risk retention amount, a number of commenters expressed concerns, primarily related to the timing and disclosure of the fair value measurement and specific accounting issues, and proposed alternative measurement methodologies to address such concerns. Many commenters also requested a “safe harbor” from liability with respect to the disclosures. In addition, several commenters argued that sponsors should not have to measure and disclose the fair value of eligible vertical interests, so long as the underlying ABS interests have a principal or notional balance. Further, numerous commenters opposed the cash flow restrictions on the eligible horizontal residual interest option, arguing that the proposed restrictions were impractical and incompatible with a variety of securitization structures in various asset classes.

Open Market Collateralized Loan Obligations:

Many commenters argued that managers of open market collateralized loan obligations (CLOs) are not “securitizers,” as defined in section 15G of the Exchange Act and, therefore, that the agencies cannot subject them to the risk retention rule. In addition, many commenters requested an exemption or reduced risk retention for open market CLOs, arguing that their structural features already protect investors and ensure high quality underwriting. Some commenters requested a new option to allow third-party investors in CLOs to hold risk retention instead of CLO managers. Commenters also generally opposed the proposed alternative risk retention option for open market CLOs, under which a lead arranger in a syndicated loan could satisfy the risk retention requirement, asserting that this option was inconsistent with current market practice and would not be adopted by lead arranger banks. Among other concerns, commenters argued that lead arranger banks would be hesitant to retain risk as proposed because holding a position that cannot be hedged or transferred might subject them to criticism from bank regulators. As a result, these commenters argued, the risk retention requirement would lead to a reduction in CLO offerings and credit to commercial borrowers.

Master Trusts/Revolving Pool Securitizations

Many commenters argued that the option for master trusts would not be useable by most revolving pool securitizations and requested technical revisions, including: giving risk retention credit for subordinated seller's interests; modifying the fair value calculations and measurement of the seller's interest; permitting risk retention in legacy master trusts to be held at the legacy master trust level for permitted horizontal forms of risk retention; permitting subordinated distributions on the seller's interest prior to an early amortization event; modifying provisions on excess funding accounts and early amortization to better reflect market practice; eliminating the separation of interest and principal waterfalls; permitting the amount offset by horizontal interests to be determined on a weighted average basis across all series of outstanding investor ABS interests; permitting, on a grandfathered basis, a revolving pool securitization that relies on horizontal interests to offset any portion of the seller's interest; and including certain series-specific interest reserve accounts as an offset to the minimum seller's interest.

Asset-Backed Commercial Paper

Many commenters requested additional forms of risk retention within the asset-backed commercial paper (ABCP) option, including standby letters of credit, guarantees, liquidity facilities, unfunded liquidity, asset purchase agreements, repurchase agreements, and other similar support arrangements and credit enhancements. Some commenters argued that arrangers and managers of ABCP conduits are not "sponsors" and therefore should not be subject to risk retention. Many commenters requested a full exemption from risk retention for ABCP conduits with certain features or structures, or for ABCP conduits with underlying assets that were originated before the applicable effective date of the rule. Many commenters expressed general support for the ABCP option, but requested additional revisions, including: extending the maximum ABCP maturity to 397 days; modifying the limitations on assets that may be acquired by ABCP conduits; permitting originator-sellers to convey to intermediate SPVs assets acquired in business combinations and asset purchases; broadening the definition of 100 percent liquidity coverage; permitting multiple liquidity providers; and reducing the disclosure requirements.

Commercial Mortgage-Backed Securities

Generally, commenters supported the proposed commercial mortgage-backed securities (CMBS) risk retention option, but some commenters requested modifications. Several commenters recommended allowing the third-party purchasers to hold the interests in a senior-subordinated structure, rather than pari passu, provided that the holder of the subordinated interest retains at least half of the requisite eligible horizontal residual interest, and that both third-party purchasers independently satisfy all of the requirements and obligations imposed on third-party purchasers. These commenters suggested that a senior-subordinated structure would better allow the market to appropriately and efficiently price the interests in a manner that is commensurate with the risk of loss of each interest, and to address the different risk tolerance levels of each third-party purchaser. Multiple commenters expressed support for the Operating Advisor requirement, but many commenters suggested different voting quorum requirements for the Operating Advisor to remove the special servicer. Many commenters argued that the five-year transfer restriction period should be reduced, because it would significantly impair the liquidity of CMBS and render the B-piece interests much less desirable, and suggested different alternative approaches.

Government-Sponsored Enterprises

The few commenters that commented on the treatment of government-sponsored enterprises under the risk retention rule were generally supportive of this option.

Municipal Bond “Repackaging” Securitizations

Many commenters requested an exemption from risk retention for tender option bonds (TOBs) or technical clarifications or adjustments to the proposed option to cover a broader range of transaction structures and current TOB programs. Commenters argued that subjecting TOBs to the risk retention requirements would significantly increase the costs of TOB programs, adversely affect the state and local governments that indirectly receive funding through these programs, and decrease the availability of tax-exempt investments in the market for money market funds. A few commenters requested that the residual interest in any TOB structure qualify as a risk retention option if the residual interest holder met certain requirements. Several commenters suggested technical clarifications, adjustments and corrections.

Foreign Safe Harbor

Commenters generally supported the safe harbor for certain foreign securitizations, but a few commenters suggested modifications, including: increasing the 10 percent limit on the value of ABS interests permitted to be sold to or for the account of U.S. persons; clarifying that the limit applies only at date of initial issuance; excluding from the limit securitization transactions with a sponsor or issuing entity that is a U.S. person which makes no offers to U.S. persons and issuances of asset-backed securities that comply with Regulation S of the Securities Act; providing for coordination of the rule with foreign risk retention requirements; and clarification on how the dollar value of ABS interests should be determined.

Qualified Residential Mortgages

Most commenters supported the agencies' proposal to align the definition of a "qualified residential mortgage" (QRM) with the definition of a "qualified mortgage" (QM) as defined under the Truth in Lending Act (TILA). Several commenters asked that the QRM definition accommodate the use of blended pools of QRM and non-QRM loans. Other commenters sought more specific expansions of the definition, including an exemption of loans originated by community development financial institutions and other community-focused lenders that are exempt from the ability-to-repay requirements (and, as a result, do not qualify to be QMs under TILA), imposition of a less than 5 percent risk retention requirement for some loans that did not qualify for QM, and the inclusion of non-U.S. originated loans. Several commenters expressed concern with both the alignment of the QRM definition with the QM definition as well as the alternative, more restrictive, definition of QRM for which the agencies had invited comment, and suggested that the agencies should use the definition of QRM published for comment in the original proposal.

Underwriting Criteria for Other Asset Classes

Commenters requested a number of modifications to the proposed underwriting standards for qualifying commercial (QCLs), commercial real estate (QCRELs), and automobile loans

(QALs). Some commenters argued that a much lower percentage of commercial, commercial real estate, and automobile loans would qualify under the proposed underwriting standards than residential mortgages would qualify as QRMs, and recommended that the underwriting criteria for QCLs, QCRELs, and QALs be modified to capture a portion of the market similar to that portion of the residential mortgage market captured by the QRM definition. Some commenters requested that the agencies reduce or remove the 50 percent limit on the reduction for blended pools of QCLs, QCRELs, and QALs, and certain commenters requested clarification on the depositor certification requirement.

Qualifying Commercial Loans

Commenters argued the proposed QCL criteria were too strict in one or more areas and suggested that the agencies relax the standards in various ways, including by: removing the straight-line amortization criterion; increasing the maximum amortization period beyond 5 years (up to 15 or 20 years); allowing payment-in-kind loans; reducing retention for debtor-in-possession situations and loans resulting from Chapter 11 exit financings; increasing the leverage ratio to 4.5x or less; and replacing the leverage ratio with a 60 percent or 50 percent debt-to-capitalization ratio. Some commenters requested that the agencies create multiple types of QCL underwriting criteria to address different industries or different types of commercial loans. Some commenters also requested that the agencies allow QCL securitizations to have reinvestment periods, so long as the new loans added to the pool would either be QCLs or not reduce the blended pool ratio below 50 percent.

Qualifying Commercial Real Estate Loans

Many commenters argued that the proposed underwriting criteria were too strict and requested that the agencies modify the QCREL criteria to allow more loans to qualify for the exemption, including by: eliminating or changing the debt service coverage ratio criteria; removing or modifying the requirement to examine two years of past borrower data; expanding the types of derivatives allowed to convert a floating rate into a fixed rate through a rate cap derivative; allowing interest-only loans with lower loan-to-value (LTV) ratios; shortening the minimum length requirement; increasing the amortization period requirement; increasing the LTV ratio requirements; and eliminating the combined LTV cap.

In addition, some commenters requested an expansion of the QCREL criteria or an additional QCREL exemption for single-borrower or single-credit transactions involving a securitization of cross-collateralized loans provided to one or more related borrowers. A few commenters requested that the agencies consider distinct QCRE loan underwriting standards for different commercial real estate sectors. Some commenters questioned the exclusion of certain land loans from the definition of commercial real estate in the original and revised proposals and suggested clarification that the exclusion did not apply to such loans, because these loans are included in many existing CMBS securitizations.

Qualifying Automobile Loans

While some commenters supported the reproposed definition of automobile loan, others argued that the reproposed definition was too narrow and inconsistent with existing market practices, and requested modifications, including: expanding the definition of QALs to include motorcycles and automobile leases; eliminating or increasing the maximum debt-to-income ratio requirement; replacing the debt-to-income ratio requirement with a payment-to-income ratio requirement; modifying the verification requirements so that originators would need to verify only debts listed on borrower's credit report and could rely on borrower stated income without verification; using a credit scoring system instead of the credit history verification criteria; and eliminating the down payment requirement.

Hedging, Transfer and Financing Restrictions

While some commenters supported the proposed restrictions on hedging, others opposed the provisions as overly restrictive or requested clarification as to the scope of the proposed restrictions. Several commenters requested clarification that the term "servicing assets" includes hedging instruments. Several commenters expressed general support for the sunset provisions but others requested shorter time period restrictions. A few commenters requested clarification for transactions that do not typically have a nominal "principal balance" and one commenter requested that the test use the cut-off date instead of the closing date for measurement.

Exemptions

Several commenters requested modifications to the proposed general exemptions from the risk retention requirement, including expansion of the exemptions for resecuritizations and for seasoned loans, or additional exemptions, including an exemption for single-borrower transactions.