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Proposed Credit Risk Retention Rules Raise Serious Concerns

The extensive commentary provided to date on the proposed credit risk retention rules (the "**Proposed Rules**") under the Dodd-Frank Act[1] raises significant concerns that are critically important to address before the final rules are adopted.[2] The six federal agencies that issued the Proposed Rules[3] have indicated that any regulatory guidance on the final risk retention rules will only be offered jointly by the appropriate Agencies responsible for the relevant aspect of the rules. Once the Proposed Rules have been adopted, the process of obtaining guidance from the Agencies will likely be burdened by administrative inertia and the inherent difficulty of inter-agency coordination, particularly when each Agency will undoubtedly have redirected its attention to the next project on its list.

Background

The Proposed Rules effectively establish four categories of securitizations: (i) securitizations that do not involve "asset backed securities"[4] ("**ABS**"); (ii) securitizations that benefit from the full faith and credit of the United States government or its agencies; (iii) securitizations of qualified residential mortgages and other enumerated assets that meet stringent underwriting criteria; and (iv) all other securitizations, including most ABS offerings.[5]

The sponsors of most covered securitizations – including sponsors of ABS offerings, whether or not the offering is registered with the SEC under the Securities Act of 1933 – are required to retain risk utilizing one of the enumerated forms of risk retention authorized under the Proposed Rules. The Proposed Rules do not impose risk retention requirements on the sponsors of securitizations described in the first three of the above categories.

The three generally authorized forms of risk retention are all based on the requirement to retain 5% based on a not-as-yet perfectly precise concept of par value: (i) retention of a vertical slice (5% of each class of ABS interests issued); (ii) retention of a horizontal first-loss slice (which can be in the form of a pre-funded

[1] The Dodd-Frank Wall Street Reform and Consumer Protection Act. The Proposed Rules implement the credit risk retention requirements of new Section 15G of the Securities Exchange Act of 1934 (the "**Exchange Act**"), which was added by Section 941(b) of the Dodd-Frank Act.

[2] We note that the comment period on the Proposed Rules is formally open until June 10, 2011.

[3] The six federal agencies tasked with the implementation mandate under the Dodd Frank Act are: the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System (the "**Federal Reserve**"), the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Securities and Exchange Commission (the "**SEC**") and the Department of Housing and Urban Development (collectively, the "**Agencies**").

[4] The term "**asset-backed security**" in the Proposed Rules has the same meaning as in Section 3(a)(77) of the Exchange Act, namely: a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including (i) a collateralized mortgage obligation; (ii) a collateralized debt obligation; (iii) a collateralized bond obligation; (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the SEC, by rule, determines to be an asset-backed security. "Asset-backed security" does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.

[5] Securitizations not involving "self-liquidating financial assets" fall outside the Proposed Rules, and the Proposed Rules cite synthetic securitizations as one example of such transactions. In addition, the Proposed Rules provide a limited safe harbor for certain foreign securitization transactions with limited connections with the U.S. and U.S. investors.

cash account) and (iii) a hybrid between the two, or "L-shaped" retention (with one-half of the dollar amount held as a vertical slice and the other half held as a first-loss slice). In addition, other forms of risk retention may be permissible if: (i) for securitizations involving at least 1,000 separate assets, ownership of a representative sample of assets designated for securitization is retained; (ii) for commercial mortgage-backed securities, the required risk tranche is sold to certain third-party purchasers; (iii) for certain revolving asset master trusts, a seller's interest is retained and (iv) for certain asset-backed commercial paper conduits, a retained residual interest is retained.

Each form of risk retention is coupled with disclosure requirements tailored to the chosen type of risk retention. The Proposed Rules further provide a limited exemption for additional risk retention of certain single-tranche re-securitizations of securities issued in securitization transactions that comply with the risk retention rules.

The Proposed Rules apply a highly onerous additional risk retention requirement to any excess spread captured at closing: the amount by which the gross proceeds of a securitization at closing exceed the par value of the ABS interests issued (excluding those required to be retained by the sponsor) will be required to be trapped in a "premium capture cash reserve account" that will be used to bear first losses prior to the allocation of losses to other interests. The Agencies fully expected that this onerous new requirement would result in securitizations not being structured to capture such excess spread.

Finally, the Proposed Rules limit the sponsor's ability to transfer any interests or assets retained by the sponsor in compliance with the risk retention requirements to any person other than a consolidated affiliate. This includes a prohibition on pledging the retained interests for non-recourse financing and limitations on hedging the financial exposure to the retained risk. Generally, the sponsor would be permitted to engage only in certain types of hedging activities provided payments thereon are not materially related to the credit risk of one or more ABS interests, assets or securitized assets that the sponsor is required to retain.[6]

Commentary

Although only a handful of substantive comments on the Proposed Rules have been formally submitted to the Agencies to date, industry participants have been deeply engaged in the regulatory process, all the more so given the relative brevity of the public comment period on rules of such extraordinary complexity and broad consequence.

A. Criticism of the Level of Risk Retention

Though the Dodd-Frank Act mandates retention of *credit risk*, the Proposed Rules attempt to implement this mandate through the requirement that the sponsor retain a specified *par amount* of the relevant securitization. Amount of the financing may be a useful surrogate for credit risk if the amount retained is a vertical strip of the various tranches. However, as the Loan Syndications and Trading Association (the "**LSTA**") has forcefully argued, applying a similar measurement principle to the horizontal (first-loss) risk retention method results in the retention of a far greater amount of actual credit risk because the entire amount retained is exposed to first losses. The LSTA has pointed out that the general risk retention rules will have a particularly negative impact on Collateralized Loan Obligations ("**CLOs**") because CLO

[6] Very helpful to understanding the wide spectrum of complex issues raised by the Proposed Rules is the testimony provided at the hearing on "Understanding the Implications and Consequences of the Proposed Rule on Risk Retention" held by the Subcommittee on Capital Markets and Government Sponsored Enterprises of the House Committee on Financial Services on April 14, 2011, as well as the testimony provided at the hearing on "The State of the Securitization Markets" held by the Subcommittee on Securities, Insurance, and Investment of the Senate Committee on Banking, Housing, & Urban Affairs on May 18, 2011.

sponsors will generally be managers,[7] only a few of which would be able to afford to retain 5% of the par value of the transaction. However, if the vertical and horizontal risk retention methods were to be calibrated so as to retain approximately the same amount of *credit risk*, then the dollar amount for a retained horizontal first loss tranche should be much smaller than that retained under a vertical allocation. If recalculated in this fashion, a CLO sponsor might be able to retain an appropriately sized horizontal slice of its securitization.

B. What is the Meaning of Par Value?

The Proposed Rules neither define nor provide a clear means by which to measure "par value". While custom in financial transactions suggests that "par value" means the stated amount of principal or liquidation preference of the securities issued by a securitization vehicle, the Proposed Rules suggest that the use of this term is intended to be closer to market value at the time ABS interests are issued. That is, one cannot, independent of some measure of market value, assign to a security a small par value (beneficial for purposes of complying with the risk retention requirement) or a large par value (beneficial for purposes of addressing premium capture). As noted by the Agencies in the release accompanying the Proposed Rules (the "**Release**"), "[t]he proposed rules do not specify a method of measuring the amount of each class, because the amount retained, regardless of method of measurement, should equal at least five percent of the par value (if any), fair value, and number of shares or units of each class."[8] In other words, there currently appears to be an implicit requirement that the retained interest adequately capture 5% of the economics of a transaction, by imposing retention of 5% of either par value or fair value, whichever is greater. In a letter filed with the Agencies on April 21, 2011, the Securities Industry and Financial Markets Association urged the Agencies to clarify, as promptly as possible, the meaning of "par value" for purposes of the Proposed Rules, noting its concern that, because of the apparent ambiguity in the meaning of "par value," the Agencies' intent may not, in critical respects, be fully and accurately reflected in the Proposed Rules.[9]

C. Criticism of the Premium Capture Cash Reserve Account

The Proposed Rules articulate several of the advantages of a functioning securitization market and acknowledge that "[w]hen properly structured, securitization provides economic benefits that lower the cost of credit to households and businesses."[10] The drivers for the cost efficiencies will frequently result in the return required by investors in securitizations to be lower than the spread available from the securitized assets – and the motivation to capture a portion of this excess spread provides one of the chief motivations of the securitization sponsor. However, as noted above, the Proposed Rules require that any excess spread monetized by the sponsor at the closing of a securitization transaction be placed into a premium capture cash reserve account in order to cover losses on the securitized assets before losses are allocated to any other class or interest. "As a likely consequence to this proposed requirements [sic], the Agencies expect that few, if any, securitizations would be structured to monetize excess spread at closing … ."[11]

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[7] *See also* Credit Risk Retention, 76 Fed. Reg. 24,090, 24,098, n. 42 (April 29, 2011).

[8] Release, 76 Fed. Reg. 24,101.

[9] *See* Comment Letter on Joint Proposed Rules Relating to Credit Risk Retention from the Securities Industry and Financial Markets Association, at 1-2 (April 21, 2011), *available at* http://www.sifma.org/Issues/item.aspx?id=24954.

[10] Release, 76 Fed. Reg. 24,095.

[11] Release, 76 Fed. Reg. 24,113.

Many industry participants have criticized this aspect of the Proposed Rules as rendering most existing securitization structures economically unworkable. Excess spread will generally not generate a risk-adjusted return sufficient for it to be feasibly monetized in the form of an equity interest. Effectively prohibiting all up-front premium capture would likely have a significant and negative impact on securitizations, contrary to the Agencies' stated goals of reinvigorating lending by opening the securitization markets. Indeed, it raises a real question of the extent to which there will be a viable securitization market for covered assets outside of government- or agency-backed securities and the other categories of assets that are not subject to risk retention requirements.

Some commentators have speculated that the motivation for the premium capture reserve account may have been to prohibit inclusion in securitization structures of interest-only tranches that pay no interest until after a "step-up" date, subject to certain conditions being met. This step-up appears to be viewed as akin to pulling out an equity cushion from underneath the other senior note investors.[12] If the Agencies' motivations are in fact narrower and aimed at curbing this sort of specific practice, it should be possible to confine the premium capture concept to certain specific structures without requiring that all monetized excess spread be captured and held for the life of the deal, regardless of the structure of the transaction.

D. Expansion of Qualified Asset Exemptions

Industry participants and numerous commentators have argued for expansion of the availability of qualified asset exemptions from the proposed risk retention requirements. Many commentators, including concerned members of Congress, have urged the Agencies to reduce the eligibility criteria for qualified residential mortgages ("**QRM**") by, among other things, lowering the down-payment requirement from the currently proposed 20%.[13] Commentators would also like to see the Agencies relax the proposed qualification standards for other asset classes and exercise their authority to exempt additional asset classes. It is important to keep in mind, however, that the qualified asset exemptions must be considered in light of the general risk retention requirements – *i.e.*, both broadly, relative to the overall securitization market, and narrowly, relative to particular asset classes. If the general risk retention requirements were to be set at workable levels, the industry need to rely on qualified asset exemptions would diminish. Conversely, if the risk retention and other related requirements are such that securitizations of asset classes outside the currently exempt categories are prohibitively expensive, achieving the goal of reinvigorating lending by opening the securitization markets will require significant expansion of the qualified asset exemptions.

Given the Agencies' express intent to impose stringent criteria for exemption qualification, which will subject many prudently underwritten transactions to the general risk retention requirements, it is particularly important to ensure that the general risk retention requirements do not produce unintended negative consequences or prevent otherwise economically sound and desirable securitizations from taking place.

E. Uniform Treatment of Different Asset Classes

The Dodd-Frank Act directed the Agencies "to establish asset classes with separate rules for securitizers of different classes of assets, including residential mortgages, commercial mortgages, commercial loans,

[12] Following step-up, interest accrued on junior tranches is released to junior noteholders, even though there may still be sufficient risk left in the transaction such that, if the markets were to reverse, the senior noteholders would be exposed to loss. In that respect, the premium capture reserve account would work similar to a dividend stopper and could probably be better structured as such.

[13] Among other criteria, QRM standards require a loan-to-value ("**LTV**") ratio of 80% for purchase mortgage transactions, a combined LTV ratio of 75% for rate and term refinance loans and a combined LTV ratio of 70% for cash-out refinance loans.

auto loans, and any other class of assets that the [Agencies] deem appropriate."[14] In its "Report to the Congress on Risk Retention" mandated by the Dodd-Frank Act and issued in October 2010, the Federal Reserve cautioned that "simple credit risk retention rules, applied uniformly across assets of all types, are unlikely to achieve the stated objective of the [Dodd-Frank] Act … ."[15] The Federal Reserve also observed that "[g]iven the degree of heterogeneity in all aspects of securitization, a single approach to credit risk retention could curtail credit availability in certain sectors of the securitization market"[16], and recommended that the Agencies consider crafting credit risk retention requirements that are tailored to each major class of securitized assets. Notwithstanding this recommendation, the Proposed Rules often take a "one size fits all" approach that, if adopted, may significantly affect the future viability of certain asset classes for securitization transactions.

For example, the Proposed Rules do not sufficiently take into account the specific characteristics of Asset-Backed Commercial Paper Conduits ("**ABCP**") and CLOs that do not fit neatly into the "originate-to-distribute" model. ABCP, unlike the more standard asset securitizations, employ credit support facilities and other credit enhancement features, as the result of which credit-worthy liquidity providers (which often are affiliates of the sponsor) assume risk far in excess of 5%.[17] At the same time, ABCP investors' investment decisions are generally driven by the credit quality of the ABCP sponsor and liquidity provider rather than the assets purchased by the ABCP. Payments on ABCP assets are not expected to serve as the source of payments made to investors. Moreover, most ABCP sponsors do not transfer any assets to the ABCP conduits they sponsor. Thus, commentators have suggested that certain aspects of the risk retention requirements imposed under the Proposed Rules should not be applicable to, and would be simply unworkable for, ABCP.[18]

As outlined above, commentators, in particular the LSTA, have also argued that many aspects of the Proposed Rules are unworkable for CLOs. The proposed risk retention options would pose a significant challenge for CLO managers, many of whom will likely be unable to utilize the vertical slice and hybrid risk retention methods due to lack of capacity and structure. The representative sample risk retention option appears unworkable for CLOs, given that most CLOs manage a much smaller number of assets than the requisite 1,000 under the Proposed Rules. While horizontal slice retention is potentially feasible for CLOs, as noted earlier, in its proposed form, it would result in retention of risk far in excess of the 5% mandated by the Dodd-Frank Act. Yet another aspect of the Proposed Rules that clearly does not fit the CLO model is the exemption for qualifying commercial loans, the underwriting standards for which have been set so conservatively that very few loans will be able to qualify for the exemption.[19] Even if a CLO were to limit its assets to such conservatively underwritten loans, the "qualifying commercial loan" exemption only permits inclusion of loans that were funded within six months prior to the closing of the CLO, thus effectively keeping CLOs that would rely on this exemption static.[20] The LSTA has indicated that both of

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[14] *See* Section 941(b) of the Dodd-Frank Act.

[15] Federal Reserve, Report to Congress on Risk Retention, at 3, *available at* http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf.

[16] *Id*. at 83-84.

[17] *See*, *e.g.*, Release, 76 Fed. Reg. 24,107.

[18] *See*, *e.g.*, Understanding the Implications and Consequences of the Proposed Rule on Risk Retention: Hearing Before the Subcommittee on Capital Markets and Government Sponsored Enterprises of the House Committee on Financial Services (April 14, 2011) ("**HCFS Hearing**") (statement of Tom Deutsch, Executive Director, American Securitization Forum).

[19] *See, e.g.*, HCFS Hearing (statement of Bram Smith, Executive Director, LSTA).

[20] *See*, *e.g.*, Release, 76 Fed. Reg. 24,170.

these requirements are inconsistent with the active management characteristics investors seek from CLO managers.

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The public comment period on the Proposed Rules is due to close on June 10, 2011, and the final rules are currently expected to be adopted by the Agencies before year-end. To date, industry participants and commentators have expressed serious concerns about numerous aspects of the Proposed Rules and the negative effects the Proposed Rules are expected to have on various segments of the securitization markets. Some commentators have even urged the Agencies to re-propose the risk retention rules for further consideration and public comment once the comments received during the current comment period have been addressed in order to allow industry participants a meaningful opportunity to seek further clarification and refinements. Given the profound effects the new risk retention rules, once adopted, will have on the U.S. securitization markets, it is imperative that adequate consideration be given to the numerous important issues raised by the Proposed Rules.

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