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September 13, 2013

Federal Agencies Re-Propose Rule on Credit Risk Retention for Asset-Backed Securities

[27561]

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TO: FIXED-INCOME ADVISORY COMMITTEE No. 23-13
SEC RULES COMMITTEE No. 36-13
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 24-13
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 22-13
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 22-13 RE: FEDERAL AGENCIES RE-PROPOSE RULE ON CREDIT RISK RETENTION FOR ASSET-BACKED SECURITIES

On August 28, 2013, the Securities and Exchange Commission ("SEC"), Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, and Department of Housing and Urban Development (together, the "Agencies") jointly re-proposed rules ("Proposed Rules") to implement the credit risk retention requirements of Section 15G of the Securities Exchange Act of 1934 ("Exchange Act"), as added by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). [1] The Proposed Rules would require securitization sponsors to retain an economic interest in the assets that they securitize. Comments on the Proposed Rules are due October 30, 2013. Those Proposed Rules that are most relevant to registered investment companies are summarized below.

We will hold a conference call on Tuesday, September 24 at 2 pm eastern time to discuss the re-proposal and ICI's possible comments. If you would like to participate on the call, please RSVP to Kiera Robinson at kiera.robinson@ici.org or 202/326-5818 and she will provide you with the dial-in number.

Background

Section 941(b) of the Dodd-Frank Act amended Section 15G of the Exchange Act to require the Agencies to jointly adopt rules that: (i) require a securitizer of an asset-backed security ("ABS") to retain not less than five percent of the credit risk of any asset that the securitizer, through the issuance of the ABS, transfers, sells, or conveys to a third party; and (ii) prohibit a securitizer from hedging or otherwise transferring the credit risk that the securitizer is required to retain under Section 15G or the rules adopted by the Agencies. Section 15G also exempts certain types of securitization transactions from the risk retention requirements and authorizes the Agencies to exempt or establish a lower risk retention requirement for other types of securitization transactions.   In April 2011, the Agencies jointly proposed rules to implement these requirements ("original proposal"). [2] In response to the over 10,000 comments they received, the Agencies have issued the Proposed Rules with significant modifications, in some cases. The Agencies state that the risk retention requirements would become effective, for securitization transactions collateralized by residential mortgages, one year after the date on which final rules are published in the Federal Register, and two years after that date for any other securitization transaction. [3]

Standard Permissible Forms of Risk Retention

The Proposed Rules expand the permissible forms through which the required amount of risk retention may be held. The primary changes to the risk retention methods are as follows: [4]

- Under the Proposed Rules, the horizontal, vertical, and L-shaped risk retention options have been combined into a single risk retention option with a flexible structure. A sponsor could satisfy its risk retention obligation by retaining an "eligible vertical interest," [5] an "eligible horizontal residual interest," [6] or any combination thereof, in a total amount equal to no less than five percent of the fair value of all ABS interests in the issuing entity that are issued as part of the securitization transaction.
- Sponsors would be required to measure their risk retention requirement using fair value, determined in accordance with U.S. generally accepted accounting principles ("GAAP"). The sponsor would be required to provide certain disclosures regarding its fair value methodology.
- Under the Proposed Rules, a sponsor could satisfy its risk retention obligation using the vertical option by either retaining at least five percent of the fair value of each class of ABS interests issued as part of the securitization transaction, or by retaining a "single vertical security." [7]
- The Proposed Rules eliminate the requirement that securitizers utilizing horizontal risk retention maintain a premium capture cash reserve account. [8]
- The Proposed Rules include new limits on payments to holders of eligible horizontal residual interests based on the fair value measurement, in order to align the sponsor's incentives with those of investors. The Proposed Rules also include a requirement that the sponsor certify to investors that it has performed the calculations required by the Proposed Rules, which measure how quickly the sponsor can be projected to recover the fair value of the eligible horizontal residual interest.
- The Proposed Rules also include disclosure requirements related to the risk retention options similar to those that were included in the original proposal, with some modifications.

Other Risk Retention Options

Master Trusts

The Proposed Rules maintain the "seller's interest" as the specific risk retention option for master trusts but have modified that option to reflect comments received, and better reflect the way revolving master trust securitizations operate in the market.

Representative Sample

Based on comments received, the Agencies declined to include a “representative sample” risk retention option in the re-proposal, concluding that the other proposed risk retention options would better achieve the purposes of Section 15G of the Exchange Act.

Asset-Backed Commercial Paper Conduits

The original proposal included an alternative risk retention option for sponsors of asset-backed commercial paper (“ABCP”) conduits, which would have been able to rely on that option or one of the standard options. The Agencies state that commenters generally supported including a risk retention option specifically for ABCP, but expressed concern with several aspects of the option. [9] In response to comments, the Agencies have retained the ABCP option but modified several of the requirements. Under the Proposed Rules for the ABCP option, among other things:

- The ABCP conduit must meet the definition under the Proposed Rules of an “Eligible ABCP Conduit,” which imposes certain structural, liquidity coverage, and collateral requirements. [10]
    - As under the original proposal, a regulated liquidity provider must have entered into a legally binding commitment to provide 100% liquidity coverage of all ABCP issued by the issuing entity. [11]
- An ABCP conduit is permitted to acquire a broader range of collateral from an originator-seller than under the original proposal. [12]
- An ABCP conduit sponsor may satisfy its risk retention requirement with respect to the issuance of ABCP by the conduit if each originator-seller that transfers assets to collateralize the ABCP issued by the conduit retains the same amount and type of credit risk as would be required if the originator-seller were the sponsor of the intermediate SPV from which the ABCP conduit acquires an ABS interest. [13]
- Both an originator-seller and a majority-owned OS affiliate may sell or transfer assets that these entities have originated to an intermediate SPV, although intermediate SPVs could not acquire assets directly from non-affiliates.
- Multiple intermediate SPVs are permitted between an originator-seller and a majority-owned OS affiliate.
- An intermediate SPV is permitted to sell ABS that it issues to third parties other than ABCP conduits.
- An eligible ABCP conduit may satisfy its risk retention obligation if, with respect to each ABS the ABCP conduit acquires from an intermediate SPV, the originator-seller or majority-owned OS affiliate retains risk in the same form, amount, and manner as would be required using the standard risk retention or revolving asset master trust options. [14]

Consistent with the original proposal, the Proposed Rules state that the sponsor of an eligible ABCP conduit would continue to be responsible for compliance.   The Proposed Rules also specify disclosure requirements for the ABCP option that are similar to the original proposal, with some changes.

Commercial Mortgage-Backed Securities

Consistent with Section 15G(c)(1)(E) of the Exchange Act, in the original proposal, the Agencies proposed to permit a sponsor of commercial mortgage-backed securities (“CMBS”)to meet its risk retention requirements if a third-party purchaser acquired an eligible horizontal residual interest in the issuing entity. [15] The CMBS risk retention option was only available for securitization transactions where commercial real estate loans constituted at least 95% of the unpaid principal balance of the assets being securitized and six proposed requirements were met. These requirements included, among others, that any third-party purchaser acquiring an eligible horizontal residual interest under the CMBS option complied with the hedging, transfer, and other restrictions applicable to such interest under the original proposal as if the third-party purchaser were a sponsor that had acquired the interest under the horizontal risk retention option.

Commenters, including ICI, raised concerns regarding the requirement for the third-party, or “B-piece buyer,” to retain its interest for the life of the transaction. [16] The Agencies have addressed this concern, along with several other concerns raised by commenters. With respect to transfer restrictions, the Proposed Rules would permit the transfer of the retained interest by any initial third-party purchaser to another third-party purchaser at any time after five years after the date of the closing of the securitization transaction, provided that the transferee satisfies the conditions applicable to the initial third-party purchaser under the CMBS option. [17] The Proposed Rules also would permit transfers by any such subsequent third-party purchaser to any other purchaser satisfying the criteria applicable to initial third-party purchasers.

Although commenters, including ICI, raised concerns about certain disclosure requirements for the CMBS option, the Agencies are retaining these requirements substantially as provided in the original proposal. These include the proposed disclosures to investors with respect to third-party purchasers, the retained residual interest (including the purchase price), the material terms of the eligible horizontal residual interest retained by each third-party purchaser, and the representations and warranties concerning the securitized assets.

Municipal Bond “Repackaging” Securitizations

Commenters, including ICI, had requested that the Agencies exempt tender option bond (“TOB”) programs and other municipal bond repackaging securitizations from the risk retention requirements. [18] The original proposal did not address the applicability of the risk retention requirements to municipal bond repackaging securitizations. The Agencies are proposing to provide two additional risk retention options for TOB programs. Specifically, the Proposed Rules provide a definition of a “qualified tender option bond entity” [19] and a definition of a “tender option bond.” [20] The Proposed Rules provide that a sponsor with respect to tender option bonds by a qualified tender option bond entity may satisfy its risk retention obligation by complying with the standard risk retention methods (i.e., vertical, horizontal, or a combination thereof), or may choose to rely on one of two additional risk retention options particular to TOBs:

- The sponsor may retain an interest that upon issuance meets the requirements of an eligible horizontal residual interest but that upon the occurrence of a “tender option termination event” as defined in Section 4.01(5) of IRS Revenue Procedure 2003-84, as amended or supplemented from time to time will meet requirements of an eligible vertical interest.
- The sponsor may satisfy its risk retention requirements by holding municipal securities from the same issuance of municipal securities deposited in the qualified tender option bond entity, the face value of which retained municipal securities is equal to 5 percent of the face value of the municipal securities deposited in the qualified tender option bond entity.

The Proposed Rules require that the sponsor provide, or cause to be provided, to potential investors prior to the sale of the ABS and, upon request, to the SEC and the appropriate Federal Banking agency, if any, specified written disclosures. The general prohibitions on transfer and hedging under the Proposed Rules also apply to any municipal securities retained by the sponsor with respect to an issuance of TOBs by a qualified tender option bond entity under the Proposed Rules.

ABS Not Subject to the Risk Retention Requirements

The Proposed Rules, like the original proposal, do not subject certain ABS sponsors to the risk retention requirements, including, but not limited to:

Government-Sponsored Enterprises

ABS guaranteed by the Federal National Mortgage Association ("Fannie Mae") or the Federal Home Loan Mortgage Corporation ("Freddie Mac;" together with Fannie Mae, the "GSEs") while they operate under the conservatorship or receivership of the Federal Housing Finance Agency with capital support from the United States, or any successor limited life regulated entities, are deemed to satisfy the risk retention requirements. [21] Similarly, the hedging and finance provisions of the Proposed Rules would not apply to the GSEs or any successor limited-life regulated entities, as long as the GSEs (or any successor entity) are operating consistently with the conditions set out in the Proposed Rules.

Qualified Residential Mortgages ("QRM")

Section 15G of the Exchange Act exempts sponsors of securitizations from the risk retention requirements if all of the assets that collateralize the securities issued in the transaction are "qualified residential mortgages" ("QRMs"). Section 15G directs the agencies to define QRM jointly, and requires that the definition of a QRM be "no broader than" the definition of a "qualified mortgage" ("QM"), which definition was recently adopted by the Consumer Finance Protection Bureau ("CFPB"). [22] The definition of QRM the Agencies had included in the original proposal was subject to significant comment. [23] In response to comments, the Agencies have determined to broaden and simplify the scope of the QRM exemption from the original proposal by proposing to define QRM to mean QM as defined in Section 129C of the Truth in Lending Act and its implementing regulations, as may be amended from time to time. By aligning the QRM definition with the QM definition, the scope of eligible loans would be expanded to include, among other things, any closed-end loan secured by a dwelling, including, but not limited to: second liens, refinancing, second or vacation homes, and home equity loans.

The Agencies are also requesting comment on an alternative approach, referred to as "QM-plus," which begins with the core QM criteria adopted by the CFPB, and then adds four additional factors. Specifically, under a QM-plus approach, a loan would have to meet the following criteria:

- Core QM criteria. A QRM would be required to meet the CFPB's core criteria for QM, including the requirements for product type, loan term, points and fees, underwriting, income and debt verification, and debt-to-income ratio ("DTI").
- One-to-four family principal dwelling. In addition, QRM treatment would only be available for loans secured by one-to-four family real properties that constitute the principal dwelling of the borrower.
- Lien requirements. All QRMs would be required to be first-lien mortgages.

- Credit history. To be eligible for QRM status, the originator would be required to determine the borrower was not currently 30 or more days past due on any debt obligation, and the borrower had not been 60 or more days past due on any debt obligations within the preceding 24 months. [24]
- Loan to value ratio. To be eligible for QRM status, the LTV at closing could not exceed 70 percent.

In seeking comment on the QM-plus approach, the Agencies note that it would cover a significantly smaller portion of the mortgage market than would the QM standard.

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endnotes

[1] See Credit Risk Retention, available at http://www.sec.gov/rules/proposed/2013/34-70277.pdf ("Release").

[2] For a summary of the original proposal, please see ICI Memorandum No. 25162 (May 2, 2011), available at http://www.ici.org/my_ici/memorandum/memo25162. ICI submitted two comment letters on the original proposal, the second jointly with several banks. See Letter to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, et al., from Karrie McMillan, General Counsel, Investment Company Institute, dated July 29, 2011, available at http://www.ici.org/pdf/25368.pdf ("ICI 2011 Letter"); Letter to Office of the Comptroller of the Currency, et al., from ICI, et al., dated August 31, 2012, available at http://www.ici.org/pdf/26456.pdf ("ICI 2012 Letter").

[3] In the original proposal, the Agencies stated their intent to jointly approve any written interpretations, written responses to requests for no-action letters and general counsel opinions, or other written interpretive guidance concerning the scope or terms of Section 15G of the Exchange Act and the final rules issued thereunder that are intended to be relied on by the public. The Agencies also stated that they intended for the appropriate Agencies to jointly approve any exemptions, exceptions, or adjustments to the final rules. In response to comments expressing concerns about the practicality and uncertainty of this process, the Agencies state that they "continue to view the consistent application of the final rule as a benefit and intend to consult with each other when adopting staff interpretations or guidance on the final rule that would be shared with the public generally." They state, however, that they are "considering whether to require that such staff interpretations and guidance be jointly issued by the agencies with rule writing authority and invite comment."

[4] Section 15G provides that the risk retention requirements must be applied to a "securitizer" of an ABS, and that a securitizer is both an issuer of an ABS or a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate or issuer. Consistent with the original proposal, the Proposed Rules define the term "sponsor" in a manner consistent with the definition of that term in the SEC's Regulation AB.

[5] Under the Proposed Rules, an “eligible vertical interest” means with respect to any securitization transaction, a single vertical security or an interest in each class of ABS interests in the issuing entity issued as part of the securitization transaction that constitutes the same portion of the fair value of each such class.

[6] Under the Proposed Rules, an “eligible horizontal residual interest” means, with respect to any securitization transaction, an ABS interest in the issuing entity: (1) that is an interest in a single class or multiple classes in the issuing entity, provided that each interest meets, individually or in the aggregate, all of the requirements of this definition; (2) with respect to which, on any payment date on which the issuing entity has insufficient funds to satisfy its obligation to pay all contractual interest or principal due, any resulting shortfall will reduce amounts paid to the eligible horizontal residual interest prior to any reduction in the amounts paid to any other ABS interest, whether through loss allocation, operation of the priority of payments, or any other governing contractual provision (until the amount of such ABS interest is reduced to zero); and (3) that has the most subordinated claim to payments of both principal and interest by the issuing entity.

[7] A single vertical security would be an ABS interest entitling the holder to a specified percentage (e.g., 5%) of the principal and interest paid on each class of ABS interest in the issuing entity (other than such single vertical security) that results in the security representing the same percentage of fair value of each class of ABS interests.

[8] The Proposed Rules retain the possibility of satisfying the horizontal residual interest option through the use of a horizontal cash reserve account at closing. They also include, and request comment on, an alternative provision for risk retention relating to the amount of principal payments received by the eligible horizontal residual interest.

[9] ICI recommended that bank-sponsored ABCP programs should be exempt from further risk retention requirements, but that if the Agencies concluded that imposing further risk retention requirements was appropriate, the parameters for the ABCP option should be redefined to better reflect current market practice. See ICI 2011 letter, supra note 2.

[10] See Proposed Rule §_.6.

[11]The Proposed Rules clarify that 100% liquidity coverage means that, in the event that the ABCP conduit is unable for any reason to repay maturing ABCP issued by the issuing entity, the total amount for which the liquidity provider may be obligated is equal to 100% of the amount of ABCP outstanding plus accrued and unpaid interest. The Agencies state that “[l]iquidity coverage that only funds performing receivables or performing ABS interests will not meet the requirements of the ABCP option.”

[12]Permitted assets include: (A) ABS collateralized solely by assets originated by an originator-seller or one or more majority-owned OS affiliates of the originator seller, and by servicing assets; (B) special units of beneficial interest or similar interests in a trust or special purpose vehicle that retains legal title to leased property underlying leases that were transferred to an intermediate SPV in connection with a securitization collateralized solely by such leases originated by an originator-seller or majority-owned OS affiliate, and by servicing assets; and (C) interests in a revolving master trust collateralized solely by assets originated by an originator-seller or majority-owned OS affiliate and by servicing assets. Under the Proposed Rules, a majority-owned OS affiliate is defined as an entity that, directly or indirectly, majority controls, is controlled by or is under common majority control with, an originator-seller participating in an eligible ABCP conduit. For purposes of

this definition, majority control means ownership of more than 50 percent of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under GAAP.

[13] An intermediate SPV is defined under the Proposed Rules as: (1) a direct or indirect wholly-owned affiliate of the originator-seller; (2) bankruptcy remote or otherwise isolated for insolvency purposes from the eligible ABCP conduit, the originator-seller, and any majority-owned OS affiliate that, directly or indirectly, sells or transfers assets to such intermediate SPV; (3) acquires assets that are originated by the originator-seller or its majority-owned OS affiliate from the originator-seller or majority-owned OS affiliate, or acquires asset-backed securities issued by another intermediate SPV or the original seller that are collateralized solely by such assets; and (4) issues ABS collateralized solely by such assets, as applicable.

[14] The Agencies note that the use of the ABCP risk retention option by the sponsor of an eligible ABCP conduit would not relieve the originator-seller from its independent obligation to comply with its own risk retention obligations, if any, under the Proposed Rules.

[15]Such interest would have had to take the same form, amount, and manner as the sponsor would have been required to retain under the horizontal risk retention option.

[16]See ICI 2011 Letter, supra note 2. ICI advocated that the Agencies propose a tiered approach under which the B-piece buyer would be required to retain its interest for a one-year period, for the following four years could transfer its interest to a “qualified transferee” that must meet the same criteria as the B-piece buyer, and for the remainder of the transaction, would not be subject to restrictions on transfer or hedging.

[17]See Proposed Rule §_.7.

[18]See ICI 2011 Letter, supra note 2; ICI 2012 Letter, supra note 2.

[19]See Proposed Rule §_.10.

[20]Id.

[21]See Proposed Rule §_.8.

[22]Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 FR 35430 (June 12, 2013), available at http://www.gpo.gov/fdsys/pkg/FR-2013-06-12/pdf/2013-13173.pdf. The final QM rule is effective January 10, 2014.

[23]ICI, on behalf of its members, supported a QRM standard that would exempt only residential mortgage-backed securities backed by very high quality loans. Some ICI members supported the QRM standard proposed in the original proposal, while others were concerned that the Agencies’ proposed standard may be somewhat too restrictive and could have negative implications for mortgage financing to credit-worthy households. See ICI 2011 Letter, supra note 2.

[24] In addition, the borrower must not have, within the preceding 36 months, been a debtor in a bankruptcy proceeding or been subject to a judgment for collection of an unpaid debt; had personal property repossessed; had any one-to-four family property foreclosed upon; or engaged in a short sale or deed in lieu of foreclosure.