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Memorandum

Securitization After Dodd-Frank: A Summary of the Final Credit Risk Retention Rules

November 18, 2014

On October 21, 2014, five federal banking and housing agencies[1] and the Securities and Exchange Commission (collectively, the "Agencies") adopted a final rule implementing the credit risk retention requirement mandated by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act for certain securitization transactions. Specifically, Section 941 of the Dodd-Frank Act added new Section 15G to the Securities Exchange Act of 1934 that directed the Agencies to adopt rules requiring sponsors of asset-backed securities to retain at least 5% of the credit risk relating to the assets that underlie such asset-backed securities. This so-called "skin in the game" requirement is intended to provide sponsors with a meaningful incentive to monitor and control the quality of securitized assets and align the interests of the sponsor with those of investors.

The risk retention requirement will become effective one year after the date on which the final rules are published in the Federal Register for securitization transactions collateralized by residential mortgages, and two years after the date on which the final rules are published in the Federal Register for any other securitization transaction. Securitizations created before the applicable effective date do not need to comply with the risk retention requirement.

Background

In adopting Section 15G of the Exchange Act, Congress sought to address certain aspects of the securitization process that it believed masked credit risks and complicated actions to mitigate losses and reduce loan

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

defaults. In particular, Congress cited an "originate to distribute" model, in which loans were made for the purpose of selling them into securitization pools without the originator retaining any risk on the assets, as leading to lax credit and loan underwriting standards, as well as to practices that rewarded volume over asset quality. Congress identified such abuses in the securitization process as a "major contributing factor" to the recent financial crisis,[2] and it adopted the credit risk retention requirement to better align the economic interests of securitizers with those of investors in asset-backed securities.

The Agencies had originally proposed rules to implement Section 941 in March 2011, and later revised and re-issued proposed rules in September 2013. The final rules generally retain the framework of the September 2013 re-proposed rules, applying the standard 5% risk retention requirement to most asset-backed securities, whether publicly or privately issued and regardless of whether they are issued or sponsored by a regulated financial institution, unless an exemption applies.

The final rules also retain the re-proposed rules' exemptions from the credit risk retention requirement for securities backed by "qualified residential mortgages"("QRMs"), qualifying commercial loans ("QCLs"), qualifying commercial real estate ("CRE") loans and qualifying automobile loans ("QALs"), and further add an exemption for certain types of community-focused residential mortgages that are not eligible for QRM status and are exempt from the ability-to-pay rules under the Truth in Lending Act ("TILA"). While most forms of third-party credit support will not satisfy the risk retention requirement under the final rules, guarantees by the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") will fulfill the sponsor's risk retention requirement for so long as these government-sponsored enterprises continue to operate under the conservatorship of the Federal Housing Finance Agency with capital support from the United States.

The General 5% Credit Risk Retention Requirement

Under the final rules, a sponsor of "asset-backed securities" (or its majority-owned affiliate) is generally required to retain at least 5% of the credit risk relating to the underlying assets (in addition to any other risk that may be retained to satisfy contractual requirements between the parties). The sponsor is generally not permitted to hedge or transfer the credit risk that it is required to retain. The term "sponsor" is defined to mean "a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity." The term "asset-backed security" is defined by incorporating the definition of that term in Section 3(a)(79) of the Exchange Act, where it is generally defined to mean "a fixed income or other security collateralized by any type of self-liquidating financial asset (including a loan, lease, mortgage, or other secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset."

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

The final rules allow a sponsor to allocate a portion of its risk retention to any originator of the securitized assets that originated at least 20% of the underlying assets. An originator may not be allocated a greater portion of the risk retention than the percentage of the securitized assets that it originated, and must acquire from the sponsor eligible horizontal and vertical interests in the same proportion as the sponsor retains. The sponsor will be responsible for the originator's compliance with, among other things, the prohibition on an originator hedging or transferring the risk it retains.

Acceptable Forms of Credit Risk Retention

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

Notably, however, third-party credit support, such as insurance policies, guarantees, liquidity facilities or standby letters of credit, will not fulfill a sponsor's risk retention obligations for a securitization transaction, since such forms of credit support generally are not funded at the closing of the transaction and therefore may not be available to absorb losses at the time they occur.

The following summarizes the acceptable forms of credit risk retention under the final rules:

1) Standard Risk Retention Option

Under the standard option, a sponsor may retain an "eligible vertical interest" in a percentage at least equal to 5%, an "eligible horizontal residual interest" in an amount at least equal to 5% of the fair value of all ABS interests in the issuing entity or any combination of the two, as long as the percentage of the eligible vertical interest retained and the percentage of the fair value of all ABS interests of the eligible horizontal interest retained total at least 5%. An eligible vertical interest is a single vertical "slice" or an interest in each class of ABS interests in the issuing entity consisting of the same proportion of each such class. An eligible horizontal residual interest is a "first-loss" interest in the issuing entity that has the most subordinate claim to payments of both principal and interest and that will bear the risk of any shortfalls in interest or principal payments due to insufficient funds on any payment date before any other ABS interests. The final rules clarify that a sponsor's requisite risk retention percentage must be determined as of the closing date of the securitization transaction, but does not mandate a minimum or specific percentage of horizontal or vertical interest that sponsors must hold when they choose to satisfy their risk retention obligation by holding a combination of vertical and horizontal interests.

In lieu of holding all or part of its risk retention in the form of an eligible horizontal residual interest, the

final rules allow a sponsor to establish and fund an eligible horizontal cash reserve account in an equivalent amount, at closing, to be held by a trustee for the benefit of the issuing entity and invested in cash and cash equivalents. The final rules include several restrictions and limitations on uses of funds in the account, intended to ensure that amounts in the account would be available to absorb losses to the same extent as an eligible horizontal residual interest. Nevertheless, the Agencies noted in the preamble to the final rules that the trust's payment of critical expenses unrelated to credit risk, such as litigation expenses or trustee or servicer expenses, would be permitted as long as those expenses would otherwise be paid prior to any payments to the holders of the ABS interests and would not be paid to parties affiliated with the sponsor.

As was required under the re-proposed rules, the final rules require sponsors retaining credit risk in the form of an eligible horizontal residual interest to provide certain fair value disclosures to investors a reasonable period of time prior to, and after, the sale of an asset-backed security. Because any pre-closing valuation information would be preliminary in nature, the final rules revise the re-proposal's disclosure requirement to allow a sponsor to provide its bona fide determination of a range of fair values for the eligible horizontal residual interest that the sponsor expects to retain at the close of the securitization transaction based on a range of specified prices, sizes and rates of interests on each tranche of the ABS interests to be issued. For post-closing disclosure requirements, however, the sponsor must provide an actual fair value measurement of the ABS interests and the eligible horizontal residual interest retained by the sponsor based on actual sale prices and finalized tranche sizes and corresponding interest rates at the closing of the securitization transaction.

2) Revolving Pool Securitizations

In securitizations collateralized by assets held in a revolving pool of collateral, such as credit card accounts or dealer floorplan loans, a sponsor typically retains a "seller's interest," which is akin to a *pari passu* participation interest in the underlying assets. Under the final rule, a sponsor of asset-backed securities issued by an issuing entity that is established to issue ABS interests on multiple issuance dates collateralized by a common pool of assets that change over time may satisfy the risk retention requirement by retaining directly or through a wholly-owned affiliate a seller's interest of at least 5% of the aggregate unpaid principal balance of all outstanding ABS investor interests issued by the issuing entity. To qualify as a seller's interest for purposes of satisfying the risk retention requirement, the interest must be collateralized by the securitized assets and servicing assets owned or held by the issuing entity (other than ineligible assets or those servicing assets allocated as collateral for a particular series).[3] Additionally, the interest must rank *pari passu* with each series of investor interests issued, or be partially or fully subordinated to one or more series

[3] Servicing assets are any rights or other assets designed to assure the servicing, timely payment, or timely distribution of proceeds to security holders, or assets related to acquiring and holding the issuing entity's securitized assets. These may include cash and cash equivalents, contract rights, derivative agreements of the issuing entity used to hedge interest rate and foreign currency risks, or the collateral underlying the securitized assets.

with respect to the allocation of all distributions and losses on the securitized assets prior to early amortization.

This 5% test must be determined and satisfied at the closing of every issuance of securities by the issuing entity and at least monthly at a seller's interest measurement date specified under the securitization transaction documents. In calculating the seller's interest percentage, the final rules permit sponsors to deduct from the aggregate unpaid principal balance of outstanding investor interests (*i.e.*, the seller's interest denominator) an amount equal to the funds held in a segregated principal accumulation account for the repayment of outstanding investor interests.

A sponsor may combine the seller's interest with an eligible horizontal residual interest and/or a residual ABS interest in excess interest and fees relating to individual series of ABS interests for purposes of meeting the 5% risk retention requirement by retaining an eligible horizontal interest in every series issued by the issuing entity and/or an eligible residual ABS interest in excess interest and fees relating to every series issued by the issuing entity and reducing its seller's interest by a corresponding percentage. The final rules also offer relief to a sponsor that suffers a decline of its seller's interest below the 5% minimum due to an early amortization of investors' interests under the terms of the revolving pool securitization, provided that the sponsor had been in full compliance with the risk retention requirements before the early amortization event and the issuing entity issues no additional interests other than to the sponsor.

3) Asset-Backed Commercial Paper Conduits

The final rules include a special risk retention option for asset-backed commercial paper ("ABCP") conduits that issue commercial paper with maturities not exceeding 397-days and that satisfy certain other requirements. This option contemplates a securitization structure in which originators of financial assets sell the assets to special purpose vehicles ("SPVs") that are either wholly-owned affiliates of the sponsor or "orphan" SPVs. The credit risk of the financial assets transferred to the intermediate SPV is typically separated into a senior interest acquired by the ABCP conduit, and a residual "first-loss" interest retained by the originator-seller. The ABCP conduit sponsor, often a bank or other regulated financial institution, typically provides or arranges for full liquidity coverage on the ABCP issued by the ABCP conduit.

Under the final rules, the ABCP conduit sponsor's risk retention requirement would be satisfied with respect to the issuance of ABCP if, among other things, (i) the originator-seller retains credit risk to the financial assets transferred to the intermediate SPV in an amount and manner as would be required under either the standard or revolving pool securitization risk retention options described above, including the respective 5% retention requirements; and (ii) the ABCP conduit sponsor approves each originator-seller and intermediate SPV, establishes criteria governing the securitized interests, and administers the ABCP conduit, including by monitoring the securitized interests and the assets supporting those interests.

The final rules require that all ABS interests acquired by an ABCP conduit be any of (i) ABS interests collateralized solely by assets originated by an originator-seller and by servicing assets, (ii) special units of beneficial interest (or "SUBIs") or similar interests in a trust or SPV that retains legal title to leased property underlying leases originated by an originator-seller that were transferred to an intermediate SPV in connection with a securitization collateralized solely by such leases and by servicing assets, (iii) ABS interests in a revolving pool securitization collateralized solely by assets originated by an originator-seller and by servicing assets, or (iv) ABS interests that are collateralized, in whole or in part, by assets acquired by an originator-seller in a business combination that qualifies for business combination accounting under GAAP, and, if collateralized in part, the remainder of such assets meet the criteria in items (i) through (iii) and that those ABS interests be acquired in an initial issuance by or on behalf of the intermediate SPV or from another eligible ABCP conduit with the same regulated liquidity provider.

The issued ABCP must have 100% liquidity coverage (in the form of a lending facility, an asset purchase agreement, a repurchase agreement or similar arrangement) from a single regulated liquidity provider. While the re-proposed rules required the issued ABCP to have a maturity of nine months or less, the final rules extend the maximum maturity for ABCP to 397 days, exclusive of grace periods and limited renewals, in recognition of the likelihood that many conduits will need to issue ABCP with longer maturities in order to accommodate the future needs of regulated institutions subject to new liquidity requirements, including the recently adopted liquidity coverage ratio and the proposed net stable funding ratio.[4]

Like other risk retention options, the ABCP conduit option requires certain disclosures to investors regarding each originator-seller's risk retention interest. However, the final rules simplify the disclosure requirements for the ABCP conduit option as compared to the re-proposed rules, requiring originator-sellers to disclose before or contemporaneously with the first sale of ABCP and at least monthly thereafter (i) the ABCP conduit's liquidity coverage arrangement, including the provider and material terms of such liquidity coverage, (iii) the asset class of the underlying securitized assets, and (iv) the originator-seller's risk retention, including the percentage amount and form (*i.e.*, horizontal residual interest, vertical interest, or revolving pool securitization seller's interest).

The use of this ABCP risk retention option by an ABCP conduit sponsor does not relieve the originator-seller from its independent obligation to comply with its own risk retention requirements. The ABCP originator-seller will be the sponsor of the ABS interests issued by the intermediate SPV, and will therefore be required under the final rules to hold an economic interest in the credit risk of the assets collateralizing those ABS interests.

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4 For more information regarding the recently adopted liquidity coverage ratio, please see our memorandum "Federal Banking Agencies Adopt Final Liquidity Coverage Ratio Regulations," dated September 24, 2014, *available at* http://www.stblaw.com/about-us/publications/details?id=c706d80e-743d-6a02-aaf8-ff0000765f2c.

4) Commercial Mortgage-Backed Securities

In the market for commercial mortgage-backed securities ("CMBS") it is common for a third party which is not the sponsor to acquire a "first-loss" position in the form of a "B-piece." To manage its risk exposure, the B-piece buyer is involved in the selection of pool assets, performs diligence on those assets, and is affiliated with the special servicer that services loans in default or having other non-payment issues. In light of this historic market practice, the final rules permit a sponsor of asset-backed securities that are collateralized solely by CRE loans and servicing assets to satisfy some or all of its risk retention requirements if, among other requirements, a third-party purchaser acquires an eligible horizontal residual interest in the issuing entity in the same form, amount and manner as would be required of the sponsor under the standard risk retention option (discussed above).

The final rules allow up to two B-piece buyers to share the retained risk, provided that each buyer's interest is *pari passu* with the other's interest and each buyer conducts an independent review of the credit risk of each asset in the pool. Each B-piece buyer must pay for the acquired first-loss position in cash at the closing of the securitization, without financing, and must perform a detailed review of the credit risk of each asset in the pool prior to the sale of the asset-back securities by examining, at a minimum, the underwriting standards, collateral and expected cash flows of each CRE loan in the pool. B-piece buyers may not be affiliated with any party to the securitization transaction other than the special servicer, investors, or originators of less than 10% of the unpaid principal balance of the securitized assets included in the transaction.

Generally, a B-piece buyer must comply with the final rules' restrictions relating to the hedging of retained interests, and may not transfer its interest for five years following closing, and, even after five years, may only transfer its interest to a different B-piece buyer satisfying the criteria applicable to initial B-piece buyers. Any subsequent B-piece buyer may similarly only transfer the interest to other B-piece buyers satisfying the criteria applicable to initial B-piece buyers. Additionally, the final rules revise the re-proposed rules to allow the risk retention obligation to terminate once all of the CRE loans in a CMBS transaction are fully defeased (*i.e.*, once cash or cash equivalents have been pledged to the issuing entity as collateral for the CRE loans sufficient to make all remaining debt service payments due on such loans, and the issuing entity has an obligation to release its lien on the loans).

In order for B-piece buyers to be able to satisfy the risk retention requirement under the final rules, the underlying transaction documents must provide for the appointment of an independent operating advisor that is not affiliated with other parties to the transaction, has no financial interest in the transaction other than its fees and is required to act in the best interest of investors as a whole. The operating advisor must have, on behalf of the investors as a whole, the ability to recommend replacement of the special servicer under certain circumstances and, if the principal balance of the B-piece declines to 25% or less of its initial

balance (by principal payments, realized losses or appraisal reduction amounts), consultative rights over major decisions of the special servicer. The Agencies declined to specify necessary criteria for operating advisors in the final rules, allowing CMBS transaction parties the flexibility to establish appropriate standards for the operating advisor in each transaction.

As with other risk retention options under the final rules, sponsors using the CMBS risk retention option must make certain required disclosures to potential investors regarding the B-piece buyer and operating advisor (*e.g.*, identifying information, description of the buyer's experience in CMBS transactions, and description of any conflicts of interest involving the operating advisor), the fair value (expressed as a percentage of the fair value of all of the ABS interests issued) and the dollar amount of the ABS interest to be acquired by each B-piece buyer, the purchase price paid for that ABS interest and other material information on the transaction.

4) Open Market Collateralized Loan Obligations

In prevailing market practice, there are CLOs involving the securitization of loans already held by a single institution or its affiliates in portfolio and CLOs involving the securitization of loans that are purchased in the secondary market, and originated and syndicated by third parties. In the case of the latter, so-called "open market CLOs," a CLO manager generally acts as the sponsor by selecting the commercial loans to be purchased by the CLO issuing entity and managing the securitized assets once transferred to the issuing entity. However, many of these CLO managers lack the balance sheet capacity to fund 5% risk retention of the CLO, and the Agencies recognized that imposing the standard risk retention option on open market CLO managers could cause significant disruption to the CLO market and consolidation among CLO managers.

Accordingly, the final rules permit the sponsor of an open market CLO transaction to satisfy the risk retention requirement if the open market CLO does not acquire or hold any assets other than CLO-eligible loan tranches and servicing assets, the open market CLO does not invest in asset-backed securities or in credit derivatives (other than transactions to hedge risks of the open market CLO) and the CLO manager is not entitled to receive any management fee or gain on sale at the time the open market CLO issues its ABS interests. In addition, all purchases of the CLO-eligible loan tranches by the CLO issuing entity are required to be open market transactions on an arm's length basis.

To qualify as a CLO-eligible loan tranche, the loan must be a senior secured syndicated loan and the lead arranger of the syndication must (i) retain at least 5% of the face amount of the CLO-eligible tranche until the repayment, maturity, involuntary and unscheduled acceleration, payment default or bankruptcy default of the loan, and (ii) take an initial allocation of at least the greater of 20% of the funded portion of the broader syndicated credit facility and the largest allocation taken by any other member of the syndicate. Holders of the CLO-eligible tranche must be given consent rights with respect to any material waivers or amendments under the loan documents, and security provisions associated with the CLO-eligible tranche

must be at least as advantageous to the holders of the CLO-eligible tranche as the terms applicable to other tranches of comparable seniority in the syndicated facility.

Unlike the re-proposed rules, the final rules do not require CLO managers to certify to investors as to the adequacy of the collateral and the attributes of the borrowers of the loans that they purchase. Instead, CLO managers must certify that they have policies and procedures to evaluate the likelihood of repayment under the purchased loans and that they have followed such policies and procedures in evaluating each CLO-eligible loan tranche.

Sponsors of CLOs securitizing loans already held by a single institution in portfolio — so-called "balance sheet CLOs" — remain subject to the standard risk retention option.

5) Municipal Bond "Repackaging" Securitizations (Tender Option Bonds)

The final rules include alternative risk retention options for certain municipal bond repackaging securitizations, known as tender option bonds ("TOBs"). A TOB typically consists of the deposit of a single issue of highly rated, long-term municipal bonds in a trust and the issuance by the trust of two classes of securities: a floating rate, puttable security known as the "floater," and an inverse floating rate security known as the "residual." Floaters, typically held by money market mutual funds, are short-term securities that are typically puttable at par on a daily or weekly basis. Highly rated institutions provide a liquidity facility to support this put right.

A sponsor of a qualified TOB may use two alternative risk retention options to satisfy its obligations under the final rules, in addition to any other available risk retention option. First, the sponsor may hold municipal securities from the same issuance deposited in the qualified TOB, the face value of which is 5% of the face value of the municipal securities deposited in the qualified TOB. Second, the sponsor may retain an interest that upon issuance meets the requirements of an eligible horizontal residual interest but upon the occurrence of certain events including bankruptcy, default or credit downgrade, will meet the requirements of an eligible vertical interest.

To be eligible for these two alternative risk retention options, the TOB may be collateralized solely by servicing assets and municipal securities, as defined in Section 3(a)(29) of the Exchange Act, all of which have the same municipal issuer and obligor. The TOB issuing entity may issue only two classes of securities, a floater and a residual, and must have 100% liquidity coverage from a regulated liquidity provider. The TOB security must entitle holders of the floater to tender their interest to the issuer at any time for a purchase price equal to the approximate amortized cost of the security, plus any accrued interest, with a notice period of up to 397 days. The final rules extend the permissible notice period from 30 days permitted in the re-proposed rules to correspond to the maximum remaining maturity of securities allowed to be purchased by money market funds under Rule 2a-7 of the Investment Company Act of 1940.

Unlike the re-proposed rules, the final rules do not require the issued TOBs to be eligible for purchase by money market mutual funds under Rule 2a-7 of the Investment Company Act. The Agencies recognized concerns that analyzing compliance with such a requirement would involve an assessment of information that might not be available to sponsors.

Restrictions on Hedging or Transferring Retained Credit Risk

As a general matter, a sponsor may not transfer any interest or assets that it is required to retain to satisfy its risk retention requirements to any person other than an affiliate that majority controls, is majority controlled by, or is under common majority control with, the sponsor. A sponsor and its affiliates are also generally restricted from hedging the credit risk that the sponsor is required to retain, and may not enter into an agreement (including an insurance contract), derivative or other position if payments thereunder are materially related to the credit risk of the ABS interests that the sponsor is required to retain and the agreement, derivative or other position reduces or limits the financial exposure of the sponsor (or any of its majority-owned affiliates) to the credit risk of those ABS interests. Furthermore, the final rules restrict a sponsor and its affiliates from pledging its retained interests as collateral for any obligation, unless the obligation is with full recourse to the sponsor or such affiliate. In the preamble to the final rules, the Agencies advise that a sponsor would not be in compliance with the rules if it were to engage in a series of transactions designed to add credit enhancement to the securitized assets in a manner that indirectly achieved a prohibited transfer or hedge of the sponsor's retained credit risk.

As discussed above, however, the final rules allow for B-piece interests in CMBS to be transferred by the initial B-piece buyers to eligible purchasers after five years, and terminates the transfer and hedging restrictions once all of the CRE loans in a CMBS transaction are fully defeased. Additionally, limited exceptions to the hedging restrictions exist for certain risks that are not materially related to the credit risk of the sponsor's retained interest or of the particular assets that underlie the securitization transaction. Permitted hedges include positions related to interest rate or foreign exchange risk arising from the retained interests or the underlying securitized assets; or the overall value of a particular broad category or index of asset-backed securities (such as home prices), subject to limitations on the portion of the index that may be represented by the specific securitization transaction or applicable issuing entities. Hedges based on securities that are backed by similar assets originated and securitized by other sponsors also are permitted.

The final rules include a "sunset" on the transfer and hedging restrictions, with separate maximum durations for the transfer and hedging restrictions applicable to residential mortgage backed securities ("RMBS") and other asset-backed security interests. Retained interests of asset-backed securities other than RMBS may be transferred or hedged after the latest of (i) the date on which the total unpaid principal balance of the collateral is reduced to 33% of the unpaid principal balance at closing, (ii) the date on which the unpaid principal balance of the ABS interests issued in the securitization is reduced to 33% of the unpaid principal

balance at closing, or (iii) two years after closing. Because residential mortgages typically have a longer duration than other assets and weaknesses in underwriting may take longer to manifest, retained interests in RMBS may be transferred or hedged after the later of (i) the date on which the unpaid principal balance of the residential mortgage collateral is reduced to 25% of the unpaid principal balance at closing, or (ii) five years after closing. In any event, however, the transfer and hedging restrictions applicable to retained interests in RMBS expire no later than seven years after the securitization's closing.

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

Risk Retention Exemption for "Qualified Residential Mortgages"

Section 15G of the Exchange Act provides that a securitizer shall not be required to retain any part of the credit risk for an asset that is transferred or sold through the issuance of asset-backed securities by the securitizer if *all* of the assets that collateralize such securities are "qualified residential mortgages." Section 15G requires that the definition of a QRM be "no broader than" the definition of a qualified mortgage (sometimes referred to herein as a "QM") under Section 129C of TILA,[5] but otherwise left it to the Agencies to define what constitutes a qualified residential mortgage.

Like the re-proposed rules, the final rules define a qualified residential mortgage as a qualified mortgage as defined by the CFPB under TILA.[6] As discussed in further detail below, the CFPB's final QM rule is concerned primarily with product features and a borrower's debt repayment capacity. The final rules include a provision, however, that will require the Agencies to periodically review the definition of QRM and its effect on the mortgage and securitization markets.

1) General Definition of Qualified Mortgages

The CFPB's final QM rule, which became effective on January 10, 2014, provides several definitions of qualified mortgages. The final rules allow a loan meeting any of these definitions to be a QRM.

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[5] The Dodd-Frank Act amended the TILA to require originators of residential mortgages to make a reasonable and good faith determination, based on verified and documented information, that the borrower has a reasonable ability to repay the loan according to its terms. To meet this standard, the Dodd-Frank Act established a rebuttable presumption and a safe harbor for loans that are qualified mortgages.

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

Below are the general requirements that must be met for a residential mortgage loan to be considered a “qualified mortgage”:

- *Regular Payments*—The loan must have regular periodic payments that are substantially equal.

- *Elimination of Nontraditional Loan Features*—The loan generally cannot have features such as negative amortization (where the principal amount increases), interest-only payments (where a borrower only pays the interest for a specified period of time so the principal does not decrease with payments), or balloon payments (where the payment is more than two times a regular periodic payment).

- *Maximum Loan Term*—The loan cannot have a term exceeding 30 years.

- *Limits on Points and Fees*—If the loan is for $100,000 or more, it cannot have points or fees greater than 3% of the total loan amount. Stricter limits apply for smaller loans.

- *Income Verification and Monthly Debt-to-Income Ratio Cap*—Creditors must satisfy general underwriting criteria for the loan, including by verifying a potential borrower’s current or reasonably expected income or assets (other than the value of the home securing the loan). The final QM rule also generally requires that monthly payments be calculated based on the highest payment that will apply in the first five years of the loan and that the borrower have a total “back-end” debt-to-income ratio no greater than 43%.

The final QM rule does not draw a distinction between higher-priced (subprime) QMs, which receive a rebuttable presumption of compliance with TILA, and QMs that are lower-priced (prime) loans, which receive a legal safe harbor for compliance. For purposes of the final risk retention rules, both higher-priced and non-higher-priced QMs are eligible as QRMs and can be pooled together in the same securitization.

2) Temporary Second Qualified Mortgage Definition

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

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

3) Small Creditors

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

4) Alternative Approach Rejected

In the re-proposed rules, the Agencies sought comment on an alternative approach to defining QRMs, which would have added additional requirements to the CFPB's QM definition such as requirements that that the loan be for a principal dwelling, be a first-lien mortgage and have a loan to value ratio of no more than 70%. In the final rules, however, the Agencies declined to adopt this alternative QM approach, noting that these additional credit overlays may have ramifications for the availability of credit that would not be outweighed by any corresponding reductions in the likelihood of default.

Risk Retention Exception for Other Qualified Asset Classes

In addition to the general exemption for qualified residential mortgages, the final rules provide special treatment for qualified loans in certain other asset classes. Asset-backed securities may be exempt from the risk retention requirement if they are collateralized exclusively by (i) qualifying commercial loans ("QCLs"), (ii) qualifying CRE loans ("QCREs"), (iii) qualifying automobile loans ("QALs"), or (iv) certain community-focused residential mortgages that are not eligible for QRM status and are exempt from the ability-to-pay rules under TILA, provided that these underlying loans meet conservative underwriting standards that ensure they are of very low credit risk. Such underwriting standards, summarized below for each qualifying asset class, are more stringent than those required under the federal banking regulators' existing supervisory guidelines.

- *Commercial Loan Asset Class*—The underwriting standards for QCLs require an originator to conduct an analysis of the borrower's ability to service all outstanding debt over the next two years and to determine that, following origination, the borrower will have a total liabilities to total tangible assets ratio of 50% or less, a leverage ratio of 3.0 or less and a debt service coverage ("DSC") ratio of no less than 1.5. The loan payment amount must be determined based on level payments of principal and interest that amortize the debt over a term no greater than five years from origination, and the primary repayment source for the loan must consist of business revenue of the borrower. Loan documentation must include covenants that restrict the borrower's ability to incur additional debt or transfer or pledge its assets. There must also be

financial reporting covenants, which provide a servicer with financial information on at least a quarterly basis.

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

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

- *Community-Focused Residential Mortgages*—The final rules add an exemption for certain community-focused residential mortgages that are not eligible for QRM status and are exempt from the ability-to-pay rules under TILA. Generally, the Agencies concluded that the loans covered by this exemption help ensure high-quality underwriting standards for securitizers and serve the public interest because they are either government-certified, or originated by government-administered programs or small non-profit programs that have a specific community mission. More specifically, the final rules exempt asset-backed securities collateralized by loans made (i) pursuant to a program administered by a Housing Finance Agency; (ii) by a designated Community Development Financial Institution; (iii) by a HUD-designated Downpayment Assistance through Secondary Financing Provider; (iv) by a HUD-designated Community Housing Development Organization undertaking a project pursuant to HUD's HOME Investment Partnership Program; (v) by certain eligible non-profit organizations that extend credit only to low and moderate income consumers; and (vi) pursuant to certain programs authorized by the Emergency Economic Stabilization Act of 2008.

When qualifying assets (qualifying commercial loans, CRE loans, automobile loans and community-focused exempted loans) are pooled with non-qualifying assets securing the same asset-backed security, the final rules permit a sponsor to reduce its required risk retention percentage by the ratio of the unpaid principal balance of qualified assets to the total unpaid principal balance of all assets in the pool, up to a maximum

reduction of 50% (*i.e.*, to a minimum risk retention percentage of 2.5%). Sponsors using this risk retention reduction for blended pools must disclose to investors, its primary Federal regulator and the SEC the manner in which it determined its aggregate risk retention requirement, and must retain records of such disclosures until three years after all securities backed by the blended pool are no longer outstanding. This treatment is not available for securitization of loans from different asset classes (*e.g.,* automobile and commercial) that secure the same asset-backed security.

Treatment of Government-Sponsored Enterprises and Government Agencies

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

Finally, the final rules exempt from the risk retention requirements securitization transactions that are sponsored by the FDIC acting as conservator or receiver under any provision of the Federal Deposit Insurance Act or its Orderly Liquidation Authority under the Dodd-Frank Act.

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