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Office of the Comptroller of the Currency
12 CFR Part 43

Federal Reserve System
12 CFR Part 244

Federal Deposit Insurance Corporation
12 CFR Part 373

Federal Housing Finance Agency
12 CFR Part 1234

Securities and Exchange Commission
17 CFR Part 246

Department of Housing and Urban Development
24 CFR Part 267
Credit Risk Retention; Rule

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 43

[Docket No. OCC–2013–0010]

RIN 1557–AD40

FEDERAL RESERVE SYSTEM

12 CFR Part 244

[Docket No. R–1411]

RIN 7100–AD70

FEDERAL DEPOSIT INSURANCE CORPORATION

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FEDERAL HOUSING FINANCE AGENCY

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 246

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DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

24 CFR Part 267

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Credit Risk Retention

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); U.S. Securities and Exchange Commission (Commission); Federal Housing Finance Agency (FHFA); and Department of Housing and Urban Development (HUD).

ACTION: Final rule.

SUMMARY: The OCC, Board, FDIC, Commission, FHFA, and HUD (the agencies) are adopting a joint final rule (the rule, or the final rule) to implement the credit risk retention requirements of section 15G of the Securities Exchange Act of 1934, as added by section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act or Dodd-Frank Act). Section 15G generally requires the securitizer of asset-backed securities to retain not less than 5 percent of the credit risk of the assets collateralizing the asset-backed securities. Section 15G includes a variety of exemptions from these requirements, including an exemption for asset-backed securities that are collateralized exclusively by residential mortgages that qualify as ''qualified residential mortgages,'' as such term is defined by the agencies by rule.

DATES: *Effective date:* The final rule is effective February 23, 2015.

Compliance dates: Compliance with the rule with respect to asset-backed securities collateralized by residential mortgages is required beginning December 24, 2015. Compliance with the rule with regard to all other classes of asset-backed securities is required beginning December 24, 2016.

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HUD: Michael P. Nixon, Office of Housing, Department of Housing and Urban Development, 451 7th Street SW., Room 10226, Washington, DC 20410; telephone number 202–402–5216 (this is not a toll-free number). Persons with hearing or speech impairments may access this number through TTY by calling the toll-free Federal Information Relay Service at 800–877–8339.

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I. Introduction

The agencies are adopting a final rule to implement the requirements of section 941 of the Dodd–Frank Act.[1] Section 15G of the Exchange Act, as added by section 941(b) of the Dodd-Frank Act, generally requires the Board, the FDIC, the OCC (collectively, the Federal banking agencies), the Commission, and, in the case of the securitization of any ''residential mortgage asset,'' together with HUD and FHFA, to jointly prescribe regulations that (i) require a securitizer to retain not less than 5 percent of the credit risk of any asset that the securitizer, through the issuance of an asset-backed security (ABS), transfers, sells, or conveys to a third party, and (ii) prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain under section 15G and the agencies' implementing rules.[2] Compliance with the final rule with respect to securitization transactions involving asset-backed securities collateralized by residential mortgages is required beginning one year after the date of publication in the **Federal Register** and with respect to securitization transactions involving all other classes of asset-backed securities is required beginning two years after the date of publication in the **Federal Register**. References in this Supplemental Information and the rule itself to the effective date of the rule (or similar references to the date on which the rule becomes effective) are to the date on which compliance is required.

Section 15G of the Exchange Act exempts certain types of securitization transactions from these risk retention requirements and authorizes the agencies to exempt or establish a lower risk retention requirement for other types of securitization transactions. For example, section 15G specifically provides that a securitizer shall not be required to retain any part of the credit risk for an asset that is transferred, sold, or conveyed through the issuance of ABS interests by the securitizer, if all of the assets that collateralize the ABS interests are ''qualified residential mortgages'' (QRMs), as that term is jointly defined by the agencies, which definition can be ''no broader than'' the definition of a ''qualified mortgage'' (QM) as that term is defined under section 129C of the Truth in Lending Act (TILA),[3] as amended by the Dodd-Frank Act, and regulations adopted thereunder.[4] In addition, section 15G provides that a securitizer may retain less than 5 percent of the credit risk of commercial mortgages, commercial loans, and automobile loans that are transferred, sold, or conveyed through the issuance of ABS interests by the securitizer if the loans meet underwriting standards established by the Federal banking agencies.[5]

Section 15G allocates the authority for writing rules to implement its provisions among the agencies in various ways. As a general matter, the agencies collectively are responsible for adopting joint rules to implement the risk retention requirements of section 15G for securitizations that are collateralized by residential mortgage assets and for defining what constitutes a QRM for purposes of the exemption for QRM-backed ABS interests.[6] The Federal banking agencies and the Commission, however, are responsible for adopting joint rules that implement section 15G for securitizations collateralized by all other types of assets,[7] and are authorized to adopt rules in several specific areas under section 15G.[8] In addition, the Federal banking agencies are jointly responsible for establishing, by rule, underwriting standards for non-QRM residential mortgages, commercial mortgages, commercial loans, and automobile loans (or any other asset class established by the Federal banking agencies and the Commission) that would qualify sponsors of ABS interests collateralized by these types of loans for a risk retention requirement of less than 5 percent.[9] Accordingly, when used in this final rule, the term ''agencies'' shall be deemed to refer to the appropriate agencies that have rulewriting authority with respect to the asset class, securitization transaction, or other matter discussed.

For ease of reference, the final rule of the agencies is referenced using a common designation of section 1 to section 21 (excluding the title and part designations for each agency). With the exception of HUD, each agency is codifying the rule within its respective title of the Code of Federal Regulations.[10] Section 1 of each

[1] Public Law 111–203, 124 Stat. 1376 (2010). Section 941 of the Dodd-Frank Act amends the Securities Exchange Act of 1934 (the Exchange Act) and adds a new section 15G of the Exchange Act. 15 U.S.C. 78o–11.

[2] *See* 15 U.S.C. 78o–11(b), (c)(1)(A) and (c)(1)(B)(ii).

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

[4] *See* 15 U.S.C. 78o–11(c)(1)(C)(iii), (e)(4)(A) and (B).

[5] *See id.* at sections 78o–11(c)(1)(B)(ii) and (2).

[6] *See id.* at sections 78o–11(b)(2), (e)(4)(A) and (B).

[7] *See id.* at section 78o–11(b)(1).

[8] *See, e.g. id.* at sections 78o–11(b)(1)(E) (relating to the risk retention requirements for ABS collateralized by commercial mortgages); (b)(1)(G)(ii) (relating to additional exemptions for assets issued or guaranteed by the United States or an agency of the United States); (d) (relating to the allocation of risk retention obligations between a securitizer and an originator); and (e)(1) (relating to additional exemptions, exceptions or adjustments for classes of institutions or assets).

[9] *See id.* at section 78o–11(b)(2)(B).

[10] Specifically, the agencies codify the rule as follows: 12 CFR part 43 (OCC); 12 CFR part 244 (Regulation RR) (Board); 12 CFR part 373 (FDIC); 17 CFR part 246 (Commission); 12 CFR part 1234 (FHFA). As required by section 15G, HUD has jointly prescribed the final rule for a securitization that is collateralized by any residential mortgage asset and for purposes of defining a qualified residential mortgage. Because the final rule exempts the programs and entities under HUD's jurisdiction

Continued

agency's rule identifies the entities or transactions subject to such agency's rule.

Consistent with section 15G of the Exchange Act, the risk retention requirements will become effective, for securitization transactions collateralized by residential mortgages, one year after the date on which the final rule is published in the **Federal Register**, and two years after the date on which the final rule is published in the **Federal Register** for any other securitization transaction.

In April 2011, the agencies published a joint notice of proposed rulemaking that proposed to implement section 15G of the Exchange Act (the ''original proposal'').[11] The agencies invited and received comment from the public on the original proposed rule. In September 2013, the agencies published a second joint notice of proposed rulemaking (the ''revised proposal'' or ''reproposal'') that proposed significant modifications to the original proposal and that again invited comment from the public.[12] As described in more detail below, the agencies are adopting the revised proposal with some changes in response to comments received.

As discussed further below, the final rule retains the framework of the revised proposal. Unless an exemption under the rule applies, sponsors of securitizations that issue ABS interests must retain risk in accordance with the standardized risk retention option (an eligible horizontal residual interest (as defined in the rule) or an eligible vertical interest (as defined in the rule) or a combination of both) or in accordance with one of the risk retention options available for specific types of asset classes, such as asset-backed commercial paper (ABCP). The final rule includes, with some modifications, those exemptions set forth in the revised proposal, including for QRMs. In addition, in response to comments and for the reasons discussed in Part VII of this Supplementary Information, the agencies are providing an additional exemption from risk retention for certain types of community-focused residential mortgages that are not eligible for QRM status under the final rule and are exempt from the ability-to-pay rules under the TILA.[13] The agencies are not exempting managers of certain collateralized loan obligations (CLOs) from risk retention, as requested by commenters, for the reasons discussed in Part III.B.7 of this Supplementary Information.

The agencies have made adjustments and modifications to the risk retention and underwriting requirements, as discussed in further detail below. Of particular note, under the final rule, the agencies are not adopting the proposed requirement that a sponsor holding an eligible horizontal residual interest be subject to the cash flow restrictions in the revised proposal or any similar cash flow restrictions. In addition, the agencies accepted commenters' views that a fair value calculation was not necessary for vertical retention and are not requiring the eligible vertical interest to be measured using fair value. The agencies are also making some adjustments to the disclosure requirements associated with the fair value calculation for an eligible horizontal residual interest. The final rule also includes a provision that requires the agencies to periodically review the definition of QRM, the exemption for certain community-focused residential mortgages, and the exemption for certain three-to-four unit residential mortgage loans and consider whether they should be modified, as discussed further below in Parts VI and VII of this Supplementary Information. The final rule also includes several adjustments and modifications to the proposed risk retention options for specific asset classes in order to address specific functional concerns and avoid unintended consequences.

A. Background

As the agencies observed in the preambles to the original and revised proposals, the securitization markets are an important link in the chain of entities providing credit to U.S. households and businesses, and state and local governments.[14] When properly structured, securitization provides economic benefits that can lower the cost of credit.[15] However, when incentives are not properly aligned and there is a lack of discipline in the credit origination process, securitization can result in harmful consequences to investors, consumers, financial institutions, and the financial system.

During the financial crisis, securitization transactions displayed significant vulnerabilities arising from inadequate information and incentive misalignment among various parties involved in the process.[16] Investors did not have access to the same information about the assets collateralizing asset-backed securities as other parties in the securitization chain (such as the sponsor of the securitization transaction or an originator of the securitized loans).[17] In addition, assets were resecuritized into complex instruments, which made it difficult for investors to discern the true value of, and risks associated with, an investment in the securitization, as well as exercise their rights in the instrument.[18] Moreover, some lenders loosened their underwriting standards, believing that the loans could be sold through a securitization by a sponsor, and that both the lender and sponsor would retain little or no continuing exposure to the loans.[19] Arbitrage between various markets and market participants, and in particular between the Enterprises and the private securitization markets, resulted in lower underwriting standards which undermined the quality of the instruments collateralized by such loans and ultimately the health of the financial markets and their participants.[20]

Congress intended the risk retention requirements mandated by section 15G to help address problems in the securitization markets by requiring that securitizers, as a general matter, retain an economic interest in the credit risk of the assets they securitize. By requiring that a securitizer retain a portion of the credit risk of the securitized assets, the requirements of section 15G provide securitizers an incentive to monitor and ensure the quality of the securitized assets

from the requirements of the final rule, HUD does not codify the rule into its title of the Code of Federal Regulations.

[11] Credit Risk Retention; Proposed Rule, 76 FR 24090 (April 29, 2011).

[12] Credit Risk Retention; Proposed Rule, 78 FR 57928 (September 20, 2013).

[13] 15 U.S.C. 1639c.

[14] Securitization may reduce the cost of funding, which is accomplished through several different mechanisms. For example, firms that specialize in originating new loans and that have difficulty funding existing loans may use securitization to access more-liquid capital markets for funding. In addition, securitization can create opportunities for more efficient management of the asset–liability duration mismatch generally associated with the funding of long-term loans, for example, with short-term bank deposits. Securitization also allows the structuring of securities with differing maturity and credit risk profiles from a single pool of assets that appeal to a broad range of investors. Moreover, securitization that involves the transfer of credit risk allows financial institutions that primarily originate loans to particular classes of borrowers, or in particular geographic areas, to limit concentrated exposure to these idiosyncratic risks on their balance sheets.

[15] *Report to the Congress on Risk Retention,* Board of Governors of the Federal Reserve System, at 8 (October 2010), *available at http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf* (Board Report).

[16] *See* Board Report at 8–9.

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

[18] *See id.*

[19] *See id.*

[20] *See, e.g.,* Viral V. Acharya, Governments as Shadow Banks: The Looming Threat to Financial Stability, at 32 (Sept. 2011), *available at http://www.federalreserve.gov/events/conferences/2011/rsr/papers/Acharya.pdf.*

underlying a securitization transaction, and, thus, help align the interests of the securitizer with the interests of investors. Additionally, in circumstances where the securitized assets collateralizing the ABS interests meet underwriting and other standards designed to help ensure the securitized assets pose low credit risk, the statute provides or permits an exemption.[21]

Accordingly, the credit risk retention requirements of section 15G are an important part of the legislative and regulatory efforts to address weaknesses and failures in the securitization process and the securitization markets. Section 15G also complements other parts of the Dodd-Frank Act intended to improve the securitization markets. Such other parts include provisions that strengthen the regulation and supervision of nationally recognized statistical rating organizations (NRSROs) and improve the transparency of credit ratings;[22] provide for issuers of registered asset-backed securities offerings to perform a review of the securitized assets underlying the asset-backed securities and disclose the nature of the review;[23] require issuers of asset-backed securities to disclose the history of the requests they received and repurchases they made related to their outstanding asset-backed securities;[24] prevent sponsors and certain other securitization participants from engaging in material conflicts of interest with respect to their securitizations;[25] and require issuers of asset-backed securities to disclose, for each tranche or class of security, information regarding the assets collateralizing that security, including asset-level or loan-level data, if such data is necessary for investors to independently perform due diligence.[26] Additionally, various efforts regarding mortgage servicing should also have important benefits for the securitization markets.[27]

The original proposal provided several options from which sponsors could choose to meet section 15G's risk retention requirements, including retention of either a 5 percent ''vertical'' interest in each class of ABS interests issued in the securitization or a 5 percent ''horizontal'' first-loss interest in the securitization, and other options designed to reflect market practice in asset-backed securitization transactions. The original proposal also included a special ''premium capture'' mechanism designed to prevent a sponsor from structuring a securitization transaction in a manner that would allow the sponsor to offset or minimize its retained economic exposure to the securitized assets.

As required by section 15G, the original proposal provided a complete exemption from the risk retention requirements for asset-backed securities that are collateralized solely by QRMs and established the terms and conditions under which a residential mortgage would qualify as a QRM.[28] The original proposal would generally have prohibited QRMs from having product features that were observed to contribute significantly to the high levels of delinquencies and foreclosures since 2007 and included underwriting standards associated with lower risk of default. The original proposal also provided that sponsors would not have to hold risk retention for securitized commercial, commercial real estate, and automobile loans that met proposed underwriting standards. In the original proposal, the agencies specified that securitization transactions sponsored by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (jointly, the Enterprises) would meet risk retention requirements for as long as the Enterprises operated under the conservatorship or receivership of FHFA with capital support from the United States.

In response to the original proposal, the agencies received comments from over 10,500 persons, institutions, or groups. A significant number of comments supported the proposed menu-based approach of providing sponsors flexibility to choose from a number of permissible forms of risk retention, although several requested more flexibility in selecting risk retention options, including using multiple options simultaneously. Many commenters expressed significant concerns with the proposed standards for horizontal risk retention and the ''premium capture'' mechanism. Other commenters expressed concerns with respect to standards in the original proposal for specific asset classes and underwriting standards for non-residential asset classes and the application of the original proposal to managers of certain CLO transactions. A majority of commenters opposed the agencies' proposed QRM standard, and several asserted that the agencies should align the QRM definition with the QM definition, then under development by the Consumer Financial Protection Bureau (CFPB).[29]

The agencies considered the many comments received on the original proposal and engaged in additional analysis of the securitization and lending markets in light of the comments. The agencies subsequently issued the reproposal in September 2013, modifying significant aspects of the original proposal and again inviting public comment on the revised design of the risk retention regulatory framework to help determine whether the revised framework was appropriately structured.

B. Overview of the Revised Proposal and Public Comment

The agencies proposed in 2013 a risk retention rule that would have retained much of the structure of the original proposal, but with more flexibility in how risk retention could be held and with a broader definition of QRM.[30]

Among other things, the revised proposal provided a variety of options for complying with a minimum 5 percent risk retention requirement, an exemption from risk retention for residential mortgage loans meeting the QRM standard, and exemptions from risk retention for auto, commercial real estate, and commercial loans that met proposed underwriting standards. With respect to the standard risk retention option, the revised proposal provided sponsors with additional flexibility in complying with the regulation. The revised proposal permitted a sponsor to satisfy its obligation by retaining any combination of an ''eligible vertical interest'' with a pro rata interest in all ABS interests issued and a first-loss ''eligible horizontal residual interest'' to meet the 5 percent minimum requirement. A sponsor using solely the vertical interest option would retain a single security or a portion of each class of ABS interests issued in the securitization equal to at least 5 percent of all interests, regardless of the nature of the interests themselves (for example, whether such interests were senior or subordinated). The agencies also proposed that the eligible horizontal residual interest be measured using fair

[21] *See* 15 U.S.C. 78o–11(c)(1)(B)(ii), (e)(1)–(2).

[22] *See, e.g.* sections 932, 935, 936, 938, and 943 of the Dodd-Frank Act (15 U.S.C. 78o–7, 78o–8).

[23] *See* section 945 of the Dodd-Frank Act (15 U.S.C. 77g).

[24] *See* section 943 of the Dodd-Frank Act (15 U.S.C. 78o–7).

[25] *See* section 621 of the Dodd-Frank Act (15 U.S.C. 77z–2a).

[26] See section 942(b) of the Dodd-Frank Act (15 U.S.C. 77g(c)).

[27] *See, e.g.,* Mortgage Servicing Rules Under the Real Estate Settlement Act (Regulation X); Final Rule, 78 FR 10696 (Feb. 14, 2013).

[28] See Original Proposal, 76 FR at 24117–24129 and 24164–24167.

[29] *See* 78 FR 6407 (January 30, 2013), as amended by 78 FR 35429 (June 12, 2013), 78 FR 44686 (July 24, 2013), and 78 FR 60382 (October 1, 2013) (collectively, ''Final QM rule'').

[30] *See* Revised Proposal, 78 FR 57928.

value. The agencies proposed a mechanism designed to limit payments to holders of an eligible horizontal residual interest, in order to prevent a sponsor from structuring a transaction so that the holder of the eligible horizontal residual interest could receive disproportionate payments with respect to its interest. In the revised proposal, sponsors were required to make a one-time cash flow projection based on fair value and certify to investors that its cash payment recovery percentages were not projected to be larger than the recovery percentages for all other ABS interests on any future payment date. The agencies also invited comment on an alternative proposal relating to the amount of principal payments received by the eligible horizontal residual interest. Under that alternative, the cumulative amount paid to an eligible horizontal residual interest on any payment date would not have been permitted to exceed a proportionate share of the cumulative amount paid to all ABS interests in the transaction.

The revised proposal also included asset class-specific options for risk retention with some modifications from the original proposal to better reflect existing market practices and operations. For example, with respect to revolving pool securitizations, the agencies removed a restriction from the original proposal that prohibited the use of the seller's interest risk retention option for master trust securitizations collateralized by non-revolving assets. With respect to ABCP conduits, the agencies made a number of modifications intended to allow the ABCP option to accommodate certain market practices discussed in the comments and to permit more flexibility on behalf of the originator-sellers and their majority-owned affiliates that finance through ABCP conduits. Similarly, the agencies modified the risk retention option designed for commercial mortgage-backed securities (CMBS) to allow for up to two third-party purchasers to retain the required risk retention interest, each taking a *pari passu* interest in an eligible horizontal residual interest.

Also responding to commenters' concerns, the revised proposal did not include the premium capture cash reserve account mechanism and ''representative sample'' option included in the original proposal. With respect to the premium capture cash reserve account mechanism, the agencies considered that using fair value to measure the standard risk retention amount would meaningfully mitigate the ability of a sponsor to evade the risk retention requirement through the use of improper deal structures intended to be addressed by the premium capture cash reserve account. With respect to the representative sample option in the original proposal, the agencies considered the comments received and eliminated the option in the revised proposal on the basis that such an option would be difficult to implement in a way that would not result in costs that outweighed its benefits.

The agencies retained, to a significant degree, standards for the expiration of the hedging and transfer restrictions in the regulation. The agencies decided in the reproposal to limit the sponsor's ability to have all or a portion of the required retention held by its affiliates to only a sponsor's majority-owned affiliates rather than all consolidated affiliates as would have been allowed in the original proposal. The agencies have included this approach in the final rule because it ensures that any loss suffered by the holder of risk retention will be suffered by either the sponsor or an entity in which the sponsor has a substantial economic interest. The agencies also largely carried over the terms of the original proposal with respect to securitizations collateralized by qualifying commercial, commercial real estate, or automobile loans, although modifications were proposed to reflect commenter observations and concerns, such as permitting junior liens to collateralize qualifying commercial loans, increasing the amortization period on commercial real estate loans to 30 years for multifamily residential qualified commercial real estate (QCRE) loans and 25 years for other QCRE loans, and amending the amortization standards for qualifying automobile loans.

The agencies also invited comment on new exemptions from risk retention for certain resecuritizations, seasoned loans, and certain types of securitization transactions with low credit risk. In addition, the agencies proposed a new risk retention option for CLOs, similar to the allocation to originator concept proposed for sponsors generally.

The agencies proposed to broaden and simplify the scope of the definition of a QRM in the revised proposal to align the definition with the definition of a QM under section 129C of the TILA [31] and its implementing regulations, as adopted by the CFPB.[32] As discussed in the revised proposal, the agencies concluded that a QRM definition that was aligned with the QM definition would meet the statutory goals and directive of section 15G of the Exchange Act to limit credit risk and preserve access to affordable credit, while at the same time facilitating compliance.

Along with this proposed approach to defining QRM, the agencies also invited comment on an alternative approach that would require that the borrower meet certain credit history criteria and that the loan be for a principal dwelling, meet certain lien requirements, and have a certain loan to value ratio.

The revised proposal included a provision excluding certain foreign sponsors of ABS interests from the risk retention requirements of section 15G of the Exchange Act, which did not differ materially from the corresponding provision in the original proposal.

In response to the revised proposal, the agencies received comments from more than 250 persons, institutions, or groups, including nearly 150 unique comment letters. The agencies received comments and observations on many aspects of the reproposed rule. Numerous commenters supported most aspects of the rule, but many suggested or asked for further modifications. As discussed in further detail below, a significant number of commenters commented on the agencies' use of fair value to measure risk retention. Commenters' key concerns included the timing of any fair value measurement and potential alternative methodologies to measuring risk retention. Many commenters also expressed concern about the proposed disclosure requirements for fair value, and some asked for a ''safe harbor'' from liability with respect to the disclosures.

As with the original proposal, a number of commenters on the revised proposal asserted that managers of open market CLOs are not ''securitizers'' within the definition in section 15G of the Exchange Act and should not be required to retain risk. In addition, commenters asked for an exemption from risk retention for CLOs that would meet certain structural criteria and for a new option to allow third-party investors in CLOs to hold risk retention instead of CLO managers. Commenters also generally opposed the agencies' proposed alternative for risk retention for open market CLOs in which a lead arranger in a syndicated loan was allowed to satisfy the risk retention requirement, asserting that this option was inconsistent with current market practice and that lead arranger banks would be hesitant to retain risk as proposed in the revised proposal without being allowed to hedge or transfer that risk because they would be

[31] 15 U.S.C. 1639c.

[32] *See* 78 FR 6407 (January 30, 2013), as amended by 78 FR 35429 (June 12, 2013) and 78 FR 44686 (July 24, 2013).

concerned about criticism from bank regulators.

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

Commenters expressed concerns on certain other aspects of the rule. Numerous commenters opposed the cash flow restrictions on the eligible horizontal residual interest option, making various assertions on impracticalities and impacts on different asset classes that could result from the restrictions. Commenters also expressed concerns about the scope of the seller's interest option for revolving pool securitization arrangements and whether it would comport with current market practices. With respect to CMBS, some commenters were concerned that the third-party purchaser options were too expansive, while other commenters asked for further reductions in the restrictions on B-piece risk retention. Commenters also asked for a number of modifications to the proposed underwriting standards for qualifying commercial, commercial real estate, and automobile loans, including an exemption for CMBS transactions where all the securitized assets are extensions of credit to one borrower or its affiliates.

C. Overview of the Final Rule

After considering all comments received in light of the purpose of the statute and concerns from investors and individuals seeking credit, and after engaging in additional analysis of the securitization and lending markets, the agencies have adopted the revised proposal with some modifications, as discussed below. The agencies are adopting the final QRM definition, as proposed, to mean a QM, as defined in section 129C of TILA [33] and its implementing regulations, as amended from time to time.[34] The agencies continue to believe that a QRM definition that aligns with the definition of a QM meets the statutory goals and directive of section 15G of the Exchange Act to protect investors and enhance financial stability, in part by limiting credit risk, while also preserving access to affordable credit and facilitating compliance. As discussed in further detail below, the agencies will review the definition of QRM periodically—beginning not later than four years after the effective date of the rule with respect to securitizations of residential mortgages, and every five years thereafter. These timeframes are designed to coordinate the agencies' review of the QRM definition with the timing of the CFPB's statutorily mandated assessment of QM, as well as to better ensure that the QRM definition continues to meet the goals and directive of section 15G. The final rule also provides that any of the agencies may request a review of the definition of QRM at any time as circumstances warrant.

In addition, the agencies are adopting the minimum risk retention requirement and risk retention options, with some modifications to address specific commenter concerns. As discussed in more detail below, and consistent with the revised proposal, the final rule applies a minimum 5 percent base risk retention requirement to all securitization transactions that are within the scope of section 15G of the Exchange Act and prohibits the sponsor from hedging or otherwise transferring its retained interest prior to the applicable sunset date. The final rule also allows a sponsor to satisfy its risk retention obligation by retaining an eligible vertical interest, an eligible horizontal residual interest, or any combination thereof as long as the amount of the eligible vertical interest and the amount of the eligible horizontal residual interest combined is no less than 5 percent. The amount of the eligible vertical interest is equal to the percentage of each class of ABS interests issued in the securitization transaction held by the sponsor as eligible vertical risk retention. The amount of eligible horizontal residual interest is equal to the fair value of the eligible horizontal residual interest divided by the fair value of all ABS interests issued in the securitization transaction. After considering the numerous comments received, the agencies have concluded that the proposed cash flow restriction on the eligible horizontal residual interest (as well as the alternative described in the reproposal) could lead to unintended consequences or have a disparate impact on some asset classes. The agencies have therefore decided not to include such restrictions under the final rule.

With respect to the proposed disclosure requirements related to the fair value calculation of eligible horizontal residual interests, the agencies continue to believe that it is important to the functioning of the final rule to ensure that investors and the markets, as well as regulators, are provided with key information about the methodologies and assumptions that are used by sponsors under the final rule to calculate the amount of their eligible horizontal residual interests in accordance with fair value standards. Because the agencies believe that disclosures of the assumptions inherent in fair value calculations are necessary to enable investors to make informed investment decisions, the agencies are generally retaining the proposed fair value disclosure requirements, with some modifications in response to commenter concern, as further discussed below.

Furthermore, as discussed in more detail below, the agencies are adopting the revised proposal's provisions for CMBS third-party purchasers with some modifications to respond to specific commenter concerns. In addition, the agencies are retaining the proposed five-year period during which transfer among qualified third-party purchasers of CMBS eligible horizontal residual interests that are retained in satisfaction of the final rule will not be permitted. The agencies are also adopting the proposed underwriting standards for commercial, commercial real estate, and automobile loans, with some minor adjustments to the commercial real estate underwriting standards as described below. The agencies are also adopting the revised proposal's treatment of allocation to originators, tender option bonds, and ABCP conduits, with some limited modifications, as described below. With respect to revolving pool securitizations—described in the reproposal as revolving master trusts—the agencies are adopting the reproposal with several refinements designed to expand availability of the seller's interest option. The final rule also contains the various proposed

[33] 15 U.S.C. 1639c.

[34] *See* Final QM rule.

exemptions for government-related transactions and certain resecuritizations from the revised proposal.

The agencies also, as proposed, are applying risk retention to CLO managers as ''securitizers'' of CLO transactions under section 15G of the Exchange Act and, as discussed in further detail below, are not adopting structural exemptions or third-party options as suggested by some commenters. After carefully considering comments, the suggested exemptions and alternatives, the purposes of section 15G of the Exchange Act, and the features and dynamics of CLOs and the leveraged loan market, the agencies have concluded that risk retention is appropriately applied to CLO managers and a structural exemption or third-party option would likely undermine the consistent application of the final rule. Furthermore, the agencies are retaining in the final rule the proposed alternative for open market CLOs whereby, for each loan purchased by the CLO, risk may be retained by a lead arranger. The agencies appreciate that this option may not reflect current practice, but have concluded that the option may provide a sound method for meaningful risk retention for the CLO market in the future.

D. Post-Adoption Interpretation and Guidance

The preambles to the original and revised proposals described the agencies' intention to jointly approve certain types of written interpretations concerning the scope of section 15G and the final rule issued thereunder. Several commenters on the original proposal, and some commenters on the reproposal, expressed concern about the agencies' process for issuing written interpretations jointly and the possible uncertainty about the interpretation of the rule that may arise due to this process.

The agencies have endeavored to provide specificity and clarity in the final rule to avoid conflicting interpretations or uncertainty. In the future, if the agencies determine that further guidance would be beneficial for market participants, the agencies may jointly publish interpretive guidance, as the Federal banking agencies have done in the past. In addition, the agencies note that market participants can, as always, seek guidance concerning the rule from their primary Federal banking regulator or, if such market participant is not a depository institution, the Commission. In light of the joint nature of the agencies' rule writing authority, the agencies 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 in order to attempt to achieve full consensus on such interpretations and guidance.[35] In order to facilitate this goal, the Federal banking agencies and the Commission intend to coordinate as needed to discuss pending requests for such interpretations and guidance, with the participation of HUD and FHFA when such agencies are among the appropriate agencies for such matters.

II. General Definitions and Scope

The original proposal defined several terms applicable to the overall rule. The original proposal provided that the proposed risk retention requirements would have applied to sponsors in securitizations that involve the issuance of ''asset-backed securities'' and defined the terms ''asset-backed security'' and ''asset'' consistent with the definitions of those terms in the Exchange Act. The original proposal noted that section 15G does not appear to distinguish between transactions that are registered with the Commission under the Securities Act of 1933 (the Securities Act) and those that are exempt from registration under the Securities Act. It further noted that the proposed definition of asset-backed security, which would have been broader than that in the Commission's Regulation AB,[36] included securities that are typically sold in transactions that are exempt from registration under the Securities Act, such as collateralized debt obligations (CDOs) and securities issued or guaranteed by an Enterprise. As a result, pursuant to the definitions in the original proposal, the proposed risk retention requirements would have applied to securitizers of offerings of asset-backed securities regardless of whether the offering was registered with the Commission under the Securities Act.

Under the original proposal, risk retention requirements would have applied to the securitizer in each ''securitization transaction,'' defined as a transaction involving the offer and sale of ABS interests by an issuing entity. The original proposal also explained that the term ''ABS interest'' would refer to all types of interests or obligations issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest, or residual interest, but would not include interests, such as common or preferred stock, in an issuing entity that are issued primarily to evidence ownership of the issuing entity, and the payments, if any, which are not primarily dependent on the cash flows of the collateral held by the issuing entity.

Section 15G stipulates that its risk retention requirements be applied to a ''securitizer'' of an asset-backed security and, in turn, that a securitizer is either an issuer of an asset-backed security 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. The original proposal discussed the fact that the second prong of this definition is substantially identical to the definition of a ''sponsor'' of a securitization transaction in the Commission's Regulation AB[37] and defined the term ''sponsor'' in a manner consistent with the definition of that term in the Commission's Regulation AB.

As noted in the original proposal, the agencies believe that applying the risk retention requirement to the sponsor of the ABS interests—as provided by section 15G—is appropriate in light of the active and direct role that a sponsor typically has in arranging a securitization transaction and selecting the assets to be securitized. This role best situates the sponsor to monitor and control the credit quality of the securitized assets. In some cases, the transfer of assets by the sponsor will take place through a wholly-owned subsidiary of the sponsor that is often referred to as the ''depositor.'' As noted above, the definition of ''securitizer'' in section 15G(a)(3)(A) includes the ''issuer of an asset-backed security.'' The term ''issuer'' when used in the federal securities laws may have different meanings depending on the context in which it is used. For example, for several purposes under the federal securities laws, including the Securities Act[38] and the Exchange

[35] These items do not include interpretation and guidance in staff comment letters and other staff guidance directed to specific institutions that is not intended to be relied upon by the public generally. Nor do they include interpretations and guidance contained in administrative or judicial enforcement proceedings by the agencies, or in an agency report of examination or inspection or similar confidential supervisory correspondence.

[36] *See* 17 CFR 229.1100 through 17 CFR 229.1123.

[37] *See* Item 1101 of the Commission's Regulation AB (17 CFR 229.1101) (defining a sponsor as ''a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.'').

[38] Section 2(a)(4) of Securities Act (15 U.S.C. 77b(a)(4)) defines the term ''issuer'' in part to include every person who issues or proposes to issue any security, except that with respect to certificates of deposit, voting-trust certificates, or collateral trust certificates, or with respect to

Act[39] (of which section 15G is a part) and the rules promulgated under these Acts,[40] the term ''issuer'' when used with respect to a securitization transaction is defined to mean the entity—the depositor—that deposits the assets that collateralize the asset-backed securities with the issuing entity. As stated in the original proposal, the agencies interpret the reference in section 15G(a)(3)(A) to an ''issuer of an asset-backed security'' as referring to the ''depositor'' of the securitization transaction, consistent with how that term has been defined and used under the federal securities laws in connection with asset-backed securities.[41]

As noted above, the rule generally applies the risk retention requirements of section 15G to a sponsor of the securitization transaction. In many cases the depositor and the sponsor are the same legal entity; however, even in cases where the depositor and the sponsor are not the same legal entity, the depositor is a pass-through vehicle for the transfer of assets and is either controlled or funded by the sponsor. Therefore, under the rule, the definition of sponsor effectively includes the depositor of the securitization transaction, and should identify the party subject to the risk retention requirements for every securitization transaction. Therefore, in the agencies' view, applying the risk retention requirement to the sponsor, as defined in the rule, substantively aligns with the definition of ''securitizer'' in section 15G of the Exchange Act.

Other than issues concerning CLOs, which are discussed in Part III.B.7; issues concerning ABCP, which are discussed in Part III.B.4; and issues concerning sponsors of municipal bond repackagings, which are discussed in Part III.B.8 of this Supplementary Information, comments with regard to the definition of securitizer or sponsor were generally limited to requests that the final rule provide that certain specified persons—such as underwriting sales agents—be expressly excluded from the definition of securitizer or sponsor for the purposes of the risk retention requirements.

In response to comments received relating to various transaction parties requesting that the agencies either designate as sponsors, or clarify would meet the requirements of the definition of sponsor, the agencies are providing some guidance with respect to the definition of sponsor. The statute and the rule define a securitizer as a person who ''organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.''[42] The agencies believe that the organization and initiation criteria in both definitions are critical to determining whether a person is a securitizer or sponsor. The agencies are of the view that, in order to qualify as a party that organizes and initiates a securitization transaction and, thus, as a securitizer or sponsor, the party must have actively participated in the organization and initiation activities that would be expected to impact the quality of the securitized assets underlying the asset-backed securitization transaction, typically through underwriting and/or asset selection. The agencies believe this interpretation of the statutory language ''organize and initiate'' is reasonable because it further accomplishes the statutory goals of risk retention—alignment of the incentives of the sponsor of the securitization transaction with the investors and improvement in the underwriting and selection of the securitized assets. Without this active participation, the holder of retention could be merely a speculative investor, with no ability to influence underwriting or asset selection. In addition, the interests of a speculative investor may not be aligned with those of other investors. For example, another asset-backed security issuer would not meet the ''organization and initiation'' criteria in the definition of ''sponsor'' as such an entity could not be the party that actively makes decisions regarding asset selection or underwriting. Additionally, the agencies believe that a party who does not engage in this type of active participation would be a third-party holder of risk retention, which (with the narrow exception of a qualified third-party purchaser in a CMBS transaction) is not an acceptable holder of retention under the rule because the participation of such a party does not result in the more direct alignment of incentives achieved by requiring the party with underwriting or asset selection authority to retain risk. Thus, for example, an entity that serves only as a pass-through conduit for assets that are transferred into a securitization vehicle, or that only purchases assets at the direction of an independent asset or investment manager, only pre-approves the purchase of assets before selection, or only approves the purchase of assets after such purchase has been made would not qualify as a ''sponsor''. If such a person retained risk, it would be an impermissible third-party holder of risk retention for purposes of the rule, because such activities, in and of themselves, do not rise to the level of ''organization and initiation''. In addition, negotiation of underwriting criteria or asset selection criteria or merely acting as a ''rubber stamp'' for decisions made by other transaction parties does not sufficiently distinguish passive investment from the level of active participation expected of a sponsor or securitizer.

The original proposal would have defined the term ''originator'' in the same manner as section 15G, namely, as a person who, through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security, and sells the asset directly or indirectly to a securitizer (*i.e.,* a sponsor or depositor). The original proposal went on to note that because this definition refers to the person that ''creates'' a loan or other receivable, only the original creditor under a loan or receivable—and not a subsequent purchaser or transferee—would have been an originator of the loan or receivable for purposes of section 15G. The revised proposal kept the definition from the original proposal.

The original proposal referred to the assets underlying a securitization transaction as the ''securitized assets,'' meaning assets that are transferred to a special purpose vehicle (SPV) that issues the ABS interests and that stand as collateral for those ABS interests. ''Collateral'' was defined as the property that provides the cash flow for payment

certificates of interest or shares in an unincorporated investment trust not having a board of directors (or persons performing similar functions), the term issuer means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which the securities are issued.

[39] *See* Exchange Act sec. 3(a)(8) (15 U.S.C. 78c(a)(8) (defining ''issuer'' under the Exchange Act).

[40] *See, e.g.,* Securities Act Rule 191 (17 CFR 230.191) and Exchange Act Rule 3b–19 (17 CFR 240.3b–19).

[41] For asset-backed securities transactions where there is not an intermediate transfer of the assets from the sponsor to the issuing entity, the term depositor refers to the sponsor. For asset-backed securities transactions where the person transferring or selling the pool assets is itself a trust (such as in an issuance trust structure), the depositor of the issuing entity is the depositor of that trust. *See* section 2 of the final rule. Securities Act Rule 191 and Exchange Act Rule 3b–19 also note that the person acting as the depositor in its capacity as depositor to the issuing entity is a different ''issuer'' from that person in respect of its own securities in order to make clear—for example—that any applicable exemptions from Securities Act registration that person may have with respect to its own securities are not applicable to the asset-backed securities. That distinction does not appear relevant here because the risk retention rule would not be applicable to an issuance by such person of securities that are not asset-backed securities.

[42] *See* 15 U.S.C. 78o–11(a)(3)(B) and section 2 of the final rule, *infra.*

of the ABS interests issued by the issuing entity. Taken together, these definitions were meant to include the loans, leases, or similar assets that the depositor places into the issuing entity at the inception of the transaction, though it would have also included other assets such as pre-funded cash reserve accounts. Commenters to the original proposal stated that, in addition to this property, the issuing entity may hold other assets. For example, the issuing entity may acquire interest rate derivatives to convert floating rate interest income to fixed rate, or the issuing entity may accrete cash or other liquid assets in reserve funds that accumulate cash generated by the securitized assets. As another example, commenters stated that an ABCP conduit may hold a liquidity guarantee from a bank on some or all of its securitized assets. The agencies retained these definitions of securitized assets and collateral in the revised proposal.

Some commenters expressed concern with respect to the scope of the terms of the definitions of asset-backed securities, securitization transactions, and ABS interests in the original proposal and suggested specific exemptions or exclusions from their application. Similarly, a number of commenters requested clarification of the scope of the definition of ''ABS interest,'' or suggested narrowing the definition, while other commenters suggested an expansion of the scope of the ''securitization transaction'' definition. Comments with regard to definitions of securitizer and sponsor in the original proposal were generally limited to requests that specified persons be expressly excluded from, or included in, the definition of securitizer or sponsor for the purposes of the risk retention requirements. The agencies determined to leave the definitions of securitizer and sponsor substantially unchanged in the revised proposal. After consideration of all the comments on the original proposal, the agencies did not believe that significant changes to most definitions applicable throughout the proposed rule were necessary and, in the revised proposal, retained most definitions as originally proposed.

The agencies did add some substantive definitions to the revised proposal, including proposing a definition of ''servicing assets,'' which would be any rights or other assets designed to assure the servicing, timely payment, or timely distribution of proceeds to security holders, or assets related or incidental to purchasing or otherwise acquiring and holding the issuing entity's securitized assets. The agencies noted in the revised proposal that such assets 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. As provided in the reproposed rule, ''servicing assets'' also include proceeds of assets collateralizing the securitization transactions, whether in the form of voluntary payments from obligors on the assets or otherwise (such as liquidation proceeds). The agencies are adopting this definition substantially as reproposed in order to ensure that the provisions appropriately accommodate the need, in administering a securitization transaction on an ongoing basis, to hold various assets other than the loans or similar assets that are transferred into the asset pool by the securitization depositor. In this way, the definition is similar to the definition of ''eligible assets'' in Rule 3a–7 under the Investment Company Act of 1940, which specifies conditions under which the issuer of non-redeemable fixed-income securities collateralized by self-liquidating financial assets will not be deemed to be an investment company.

In light of the agencies' adoption of the QRM definition from the reproposal and the exemption for certain three-to-four unit residential mortgages (as discussed in section VII below), the agencies are modifying the proposed definition of ''residential mortgage'' to clarify that all loans secured by 1–4 unit residential properties will be ''residential mortgages'' for the purposes of the final rule and subject to the rule's provisions regarding residential mortgages (such as the sunset on hedging and transfer restrictions specific to residential mortgages) if they do not qualify for an exemption. Under the final rule, a residential mortgage would mean a residential mortgage that is a ''covered transaction'' as defined in the CFPB's Regulation Z;[43] any transaction that is specifically exempt from the definition of ''covered transaction'' under the CFPB's Regulation Z;[44] and, as a modification to the proposed definition, any other loan secured by a residential structure that contains one to four units, whether or not that structure is attached to real property, including condominiums, and if used as residences, mobile homes and trailers.[45] Therefore, the term ''residential mortgage'' would include home equity lines of credit, reverse mortgages, mortgages secured by interests in timeshare plans, temporary loans, and certain community-focused residential mortgages further discussed in Part VII of this Supplementary Information. It would also include mortgages secured by 1–4 unit residential properties even if the credit is deemed for business purposes under Regulation Z.

Many comments on the revised proposal were similar to, or repeated, the comments on the original proposal. Some commenters asked that specific definitions be added to the rule, such as eligible participation interest, owner's interest, and participant's interest. With respect to the definitions of securitizer and sponsor, several commenters on the revised proposal requested that the final rule expressly exempt, or include, certain categories or groups of persons—such as underwriting sales agents, multiple sponsors of transactions, affiliated entities, or, in the case of tender-option bonds and ABCP, brokers who acquire and securitize assets at the direction of a third party. Other commenters requested confirmation that certain categories of transactions would not qualify as a sale or transfer of an interest for purposes of the rule.

Three commenters requested that the agencies reconsider their decision to treat non-economic residual interests in real estate investment conduits (REMICS) as ABS interests, noting the potential negative tax consequences for sponsors of REMICS. Another commenter requested that lower-tier REMIC interests in tiered structures be exempted from treatment as ABS interests, and a separate commenter requested an express exclusion of REMIC residual interests entirely. One commenter again asserted that the definition of ''securitization transaction'' was overly broad because it would include a variety of corporate debt repackagings, which the commenter asserted should be expressly exempt from risk retention. One commenter requested clarification that issuers of securities collateralized by qualifying assets could hold hedging agreements, insurance policies, and other forms of credit enhancement as permitted by the Commission's Regulation AB. One commenter asked that the definition of commercial real estate be revised to include land loans, including loans made to owners of fee interests in land leased to third parties who own improvements on the land.

While the final rule generally retains the definitions in the revised proposal, to address the concerns raised by

[43] *See* 12 CFR 1026.43.

[44] *See* 12 CFR 1026.43.

[45] This addition to the definition is substantially similar to the CFPB's definition of ''dwelling'' in Regulation Z. *See* 12 CFR 1026.2(19).

commenters with respect to REMICs,[46] the agencies have modified the definition of ABS interest to exclude (i) a non-economic residual interest issued by a REMIC and (ii) an uncertificated regular interest in a REMIC that is held only by another REMIC, where both REMICs are part of the same structure and a single REMIC issues ABS interests to investors. The agencies do not believe that significant changes to the general definitions are necessary or appropriate in light of the purposes of the statute. All adjustments to the general definitions are discussed below in this Supplementary Information in the context of relevant risk retention options.

III. General Risk Retention Requirement

A. Minimum Risk Retention Requirement

Section 15G of the Exchange Act generally requires that the agencies jointly prescribe regulations that require a securitizer to retain not less than 5 percent of the credit risk for any asset that the securitizer, through the issuance of ABS interests, transfers, sells, or conveys to a third party, unless an exemption from the risk retention requirements for the securities or transaction is otherwise available (*e.g.,* if the ABS interests are collateralized exclusively by QRMs). Consistent with the statute, the reproposal generally would have required that a sponsor retain an economic interest equal to at least 5 percent of the aggregate credit risk of the assets collateralizing an issuance of ABS interests (the base risk retention requirement). For securitizations where two or more entities would each meet the definition of sponsor, the reproposal would have required that one of the sponsors retain the credit risk of the securitized assets in accordance with the requirements of the rule. Under the reproposal, the base risk retention requirement would have been available as an option to sponsors of all securitization transactions within the scope of the rule, regardless of whether the sponsor was an insured depository institution, a bank holding company or subsidiary thereof, a registered broker-dealer, or another type of entity.

Some comments addressed the proposed minimum risk retention requirement. One commenter expressed support for the proposed minimum requirement of 5 percent risk retention, asserting that such a requirement would promote higher quality lending, protect investor interests, and limit the originate-to-distribute business model. Other commenters requested a higher minimum risk retention requirement depending on asset quality. One commenter asserted that 5 percent should be the minimum and that the purpose of risk retention would be defeated by applying 5 percent to situations in which assets are sold at a discount from par. That commenter proposed that the requirement should be either (i) the greater of 5 percent or the expected losses on the assets or (ii) the greater of 5 percent or the conditional expected losses on the assets or asset class under a moderate economic stress environment. Another commenter stated that some sponsors hold less than 5 percent because of the high quality of some assets, and requiring 5 percent retention could potentially double costs in some instances. Another commenter asserted that retaining 5 percent may not be sufficient as many sponsors held more than 5 percent credit risk in their securitizations before the crisis. That same commenter stated that investors were likely to insist that originators retain some credit risk. One commenter proposed a minimum risk retention requirement of 20 percent, while another commenter requested that sponsors be required to hold 100 percent risk retention for a specified period of time. For securitizations where multiple entities each meet the definition of sponsor, one commenter stated that multiple sponsors should be permitted to allocate the required amount of risk retention among themselves, so long as the aggregate amount retained satisfies the requirements of the risk retention rules. Other commenters requested a lower minimum for pools that blend assets that would be exempt from risk retention by meeting the proposed underwriting standards with assets not meeting the standards, which is discussed in further detail in Part V of this Supplementary Information.

After careful consideration of the comments received, the agencies are adopting the minimum risk retention requirement as proposed. Consistent with the reproposal and the general requirement in section 15G of the Exchange Act, the final rule applies a minimum 5 percent base risk retention requirement to all securitization transactions within the scope of section 15G, unless an exemption under the final rule applies.[47] The agencies believe that this requirement will provide sponsors with an incentive to monitor and control the underwriting of securitized assets and help align the interests of the sponsor with those of investors in the ABS interests. The agencies note that, while Congress directed that the rule include a risk retention requirement of no less than 5 percent of the credit risk for any asset, parties to a securitization transaction may agree that more risk will be retained. While some commenters asked that the rule calibrate the credit risk on an asset class basis (*i.e.,* make a determination that the credit risk associated with certain asset classes is lower than for other asset classes), the agencies are declining to do that at this time because the data provided by commenters do not provide a sufficient basis for the calibration of credit risk on an asset class basis.[48] For securitizations where two or more entities would each meet the definition of sponsor, the final rule requires that one of the sponsors complies with the rule, consistent with the original and revised proposals. The final rule does not prohibit multiple sponsors from retaining credit risk as long as one of those sponsors complies with the requirements of the final rule. The agencies are not allowing sponsors to divide the required risk retention generally because allowing multiple sponsors to divide required risk retention among themselves would dilute the economic risk being retained and, as a result, reduce the intended alignment of interest between the sponsor and the investors.

The agencies do not believe that it is necessary or appropriate to attempt to vary the amount of risk retention based on the quality of the assets or other factors and believe that attempting to do so would unnecessarily complicate compliance with the rule. As discussed below, the agencies are adopting the requirement that an eligible horizontal

[46] Some commenters expressed concern that including REMICs in the ABS interest definition would create tax liabilities unrelated to the credit risk of the underlying collateral and would likely reduce the intended impact of the risk retention rules since non-economic residual interests usually have a negative value.

[47] *See* final rule at sections 3 through 10. Similar to the proposal, the final rule, in some instances, permits a sponsor to allow another person to retain the required amount of credit risk (*e.g.,* originators, third-party purchasers in CMBS transactions, and originator-sellers in ABCP conduit securitizations). However, in such circumstances, the final rule includes limitations and conditions designed to ensure that the purposes of section 15G continue to be fulfilled. Further, even when another person is permitted to retain risk, the sponsor still remains responsible under the rule for compliance with the risk retention requirements, as discussed below.

[48] As required by section 15G, the agencies have established automobile, commercial real estate, and commercial loan asset classes and related underwriting standards designed to ensure a low credit risk for assets originated to those standards. The agencies provided for zero risk retention for loans meeting the prescribed underwriting standards.

residual interest be measured at fair value using a fair value methodology acceptable under U.S. generally accepted accounting principles (GAAP). The agencies believe that generally requiring that retention be 5 percent of the fair value of the ABS interests issued in the securitization transaction will sufficiently calibrate the actual amount of retention to the value of the assets, including how that value may be affected by expected losses. In addition, subject to limited exceptions, such as that applicable to transfers of CMBS interests among qualified third-party purchasers after five years, transfers to majority-owned affiliates, and certain permitted hedging activities, the final rule prohibits the sponsor from hedging or otherwise transferring its retained interest prior to the applicable sunset date, as discussed in Part IV.F of this Supplementary Information.

The agencies note that the base risk retention requirement is a regulatory minimum and not a limit on what investors or other market participants may require. The sponsor, originator, or other party to a securitization may retain additional exposure to the credit risk of assets that the sponsor, originator, or other party helps securitize beyond that required by the rule, either on its own initiative or in response to the demands or requirements of private market participants.

B. Permissible Forms of Risk Retention—Menu of Options

Section 15G of the Exchange Act expressly provides the agencies the authority to determine the permissible forms through which the required amount of risk retention must be held.[49] Accordingly, the reproposal, like the original proposal, would have provided sponsors with multiple options to satisfy the risk retention requirements of section 15G. The flexibility provided in the reproposal's menu of options for complying with the risk retention requirement was designed to take into account the heterogeneity of securitization markets and practices and to reduce the potential for the proposed rules to negatively affect the availability and costs of credit to consumers and businesses. As proposed, the menu of options approach was designed to be consistent with the various ways in which a sponsor or other entity, in historical market practices, may have retained exposure to the credit risk of securitized assets.[50] Historically, whether or how a sponsor retained exposure to the credit risk of the assets it securitized was determined by a variety of factors including the rating requirements of the NRSROs, investor preferences or demands, accounting and regulatory capital considerations, and whether there was a market for the type of interest that might ordinarily be retained (at least initially by the sponsor).

Commenters generally supported the menu-based approach of providing sponsors with the flexibility to choose from a number of permissible forms of risk retention. While commenters were generally supportive of a menu-based approach, several commenters requested that the final rule provide additional options and increased flexibility for sponsors to comply with the risk retention requirement. In this regard, several commenters asserted that the final rule should permit third-party credit support as additional forms of risk retention, including insurance policies, guarantees, liquidity facilities, and standby letters of credit. One commenter stated that such unfunded forms of credit support are permitted by the European risk retention framework and allowing similar options would provide greater consistency between the U.S. and European rules. This commenter further contended that the final rule, at a minimum, should permit such forms of unfunded risk retention for a subset of sponsors, such as regulated banks. A few commenters requested that overcollateralization be permitted as an alternative method of risk retention. Further, the agencies received several comments requesting that the final rule include an option allowing retention to be held in the form of interests in the securitized assets themselves. Along these lines, several commenters sought additional flexibility under the rule to hold risk retention as loan participation interests or companion notes instead of an ABS interest. One commenter stated that, while the use of participations in securitization transactions may not currently be customary, sponsors may find such a structure advantageous in connection with the risk retention requirements. A few commenters said that *pari passu* participation interests and structures using *pari passu* companion notes have been used in certain types of CMBS transactions. Other commenters requested that the final rule allow for subordinated participation interests. These commenters said *pari passu* participations should qualify as vertical risk retention and subordinate participation interests should qualify as horizontal risk retention. The main reason cited by these commenters for expanding the forms of risk retention recognized under the rule to include this form of retention, other than future flexibility as to form, was the possibility that the sponsor could hold the same economic exposure it would have as an ABS interest form of risk retention, while at the same time incurring lower regulatory capital charges for that exposure by holding it as a loan, and avoiding consolidation of the structure onto its balance sheet. Another commenter suggested that the availability of a participation option may be important for commercial banks because of their existing infrastructure to share risk on a *pari passu* basis.

One commenter stated that the final rule should provide more flexibility by allowing sponsors to satisfy their risk retention requirement through a combination of means and that the rule should not mandate forms of risk retention for specific types of asset classes or specific types of transactions.

The agencies have carefully considered the comments and are adopting the proposed menu of options approach to risk retention largely as proposed. The agencies continue to believe that providing options for risk retention is appropriate in order to accommodate the variety of securitization structures that will be subject to the final rule and that the menu of options, as proposed, provides sufficient flexibility for sponsors to satisfy their risk retention obligations.

After carefully considering the comments requesting loan interests, such as loan participations, as an option, the agencies have decided not to expand the recognized legal forms of risk retention under the rule beyond ABS interests by including *pari passu* participation interests, subordinated participation interests, *pari passu* companion notes, or subordinated companion notes. The agencies are permitting specialized forms of participations for two particular asset classes as discussed below in connection with CLO securitizations and tender option bonds, subject to several requirements under the rule. However, the agencies believe that the rule already provides sufficient flexibility as to the economic forms of risk retention and an additional form of

[49] *See* 15 U.S.C. 78o–11(c)(1)(C)(i); *see also* S. Rep. No. 111–176, at 130 (2010) (''The Committee [on Banking, Housing, and Urban Affairs] believes that implementation of risk retention obligations should recognize the differences in securitization practices for various asset classes.'').

[50] *See* Board Report; *see also Macroeconomic Effects of Risk Retention Requirements,* Chairman of the Financial Stability Oversight Counsel (January 2011), *available at http://www.treasury.gov/initiatives/wsr/Documents/Section946RiskRetentionStudy(FINAL).pdf.*

risk retention is not necessary. The agencies are concerned that offering different legal forms, such as participation interests or companion loans, as a standard option would introduce substantial complexity to the rule in order to ensure that these forms of retention were implemented in a way that ensured that the holder had the same economic exposure as the holder of an ABS interest. In addition, given the commenters' reasons for requesting that these options be made available, the agencies are concerned that permitting these types of interests to be held as retention could raise concerns about regulatory capital arbitrage.

The agencies do not believe it would be appropriate to allow sponsors to satisfy risk retention obligations through third-party credit support, such as insurance policies, guarantees, liquidity facilities, or standby letters of credit. As discussed in the reproposal, such forms of credit support generally are not funded at closing and therefore may not be available to absorb losses at the time they occur. Except in the case of the guarantees from the Enterprises under the conditions specified, which include the Enterprises' operating in conservatorship or receivership with capital support from the United States, the agencies continue to believe that unfunded forms of risk retention fail to provide sufficient alignment of incentives between sponsors and investors and are not including them as eligible forms of risk retention.

The final rule does not permit overcollateralization as a standard method of risk retention. While overcollateralization may provide credit enhancement to a securitization, the agencies do not believe that a credit risk retention option based solely on a comparison of the face value [51] of the securitized assets and the face value of the ABS interests would provide meaningful risk retention consistent with the goals and intent of section 15G because the face value of both the securitized assets and the face value of the ABS interests can materially differ from their relative value and/or cost to the sponsor.[52] Moreover, the fair value of an eligible horizontal residual interest takes into consideration the overcollateralization and excess spread in a securitization transaction as adjusted by expected loss and other factors. Further, for the reasons discussed in Part III.B.3 of this Supplementary Information, the final rule does not include a representative sample option.

As in the reproposal, the permitted forms of risk retention in the final rule are subject to terms and conditions that are intended to help ensure that the sponsor (or other eligible entity) retains an economic exposure equivalent to 5 percent of the credit risk of the securitized assets at a minimum. As described below, the final rule includes several modifications to the various forms of risk retention, as well as the terms and conditions that were proposed, to help ensure that sponsors have a meaningful stake in the overall performance and repayment of the assets that they securitize. Each of the forms of risk retention permitted by the final rule and the measures intended to ensure that sponsors retain meaningful credit risk are described below.

1. Standard Risk Retention

a. Structure of Standard Risk Retention Option

Under the revised proposal, standard risk retention could have been used by a sponsor for any securitization transaction.[53] Standard risk retention could have taken the form of: (i) Vertical risk retention; (ii) horizontal risk retention; and (iii) any combination of vertical and horizontal risk retention.[54] Under the reproposal, a sponsor would have been permitted to satisfy its risk retention obligation by retaining an eligible vertical interest, an eligible horizontal residual interest, or any combination thereof, in a total amount equal to no less than 5 percent of the fair value of all ABS interests in the issuing entity that are issued as part of the securitization transaction.

Through the vertical option, the reproposal would have allowed a sponsor to satisfy its risk retention obligation with respect to a securitization transaction by retaining at least 5 percent of the fair value of each class of ABS interests issued as part of the securitization transaction. This would provide the sponsor with an interest in the entire securitization transaction. As an alternative, the reproposal would have allowed a sponsor to satisfy its risk retention requirement under the vertical option by retaining a single vertical security. As discussed in the reproposal, a single vertical security would be an ABS interest entitling the holder to a specified percentage (*e.g.,* 5 percent) of the principal and interest paid on each class of ABS interests in the issuing entity (other than such single vertical security) that result in the security representing the same percentage of fair value of each class of ABS interests.

Under the reproposal, a sponsor also would have been permitted to satisfy its risk retention obligation by retaining an eligible horizontal residual interest in the issuing entity in an amount equal to no less than 5 percent of the fair value of all ABS interests in the issuing entity that are issued as part of the securitization transaction. In lieu of holding all or part of its risk retention in the form of an eligible horizontal residual interest, the reproposal would have allowed a sponsor to cause to be established and funded, in cash, a reserve account at closing (eligible horizontal cash reserve account) in an amount equal to the same dollar amount (or corresponding amount in the foreign currency in which the ABS interests are issued, as applicable) as would be required if the sponsor held an eligible horizontal residual interest.[55]

As reproposed, an interest would have qualified as an eligible horizontal residual interest only if it was an interest in a single class or multiple classes in the issuing entity with respect to which, on any payment date on which the issuing entity would have insufficient funds to satisfy its obligation to pay all contractual interest or principal due, any resulting shortfall would reduce amounts paid to the eligible horizontal residual interest prior to any reduction in the amounts paid to any other ABS interest until the amount of such ABS interest is reduced to zero. The eligible horizontal residual interest would have been required to have the most subordinated claim to payments of both principal and interest by the issuing entity.

Many commenters generally supported the reproposal to allow a sponsor to meet its risk retention

[51] The agencies are using the term ''face value'' to mean the outstanding principal balance of a loan or other receivable or an ABS interest and, with respect to an asset that does not have a stated principal balance, it means an equivalent value measurement, such as securitization value.

[52] The agencies have adopted a risk retention option for revolving pool securitizations that relies heavily on a comparison of the face value of the securitized assets and the face value of the ABS interests. However, reliance on the seller's interest option is limited to revolving pool securitizations that include certain structural features and alignment of incentives to address many of the concerns the agencies had with respect to the reliance on face value to measure required credit risk retention. See Part III.B.2 of this Supplementary Information.

[53] As discussed above, in the original proposal, a sponsor using standard risk retention would have had to choose between a 5 percent horizontal interest, 5 percent vertical interest, or a combination of horizontal and vertical interests that was approximately half horizontal and half vertical. The agencies reproposed standard risk retention with a more flexible structure in response to concerns raised by commenters on the original proposal. *See* Revised Proposal, 78 FR at 57937.

[54] *See* Revised Proposal, 78 FR at 57937.

[55] *See* Revised Proposal, 78 FR 57939.

obligation by retaining an eligible vertical residual interest, an eligible horizontal residual interest, or any combination of such interests. Such commenters generally approved of the flexibility that the reproposal would provide to sponsors in structuring their risk retention. Further, one commenter expressed support for the single vertical security option, asserting that it would simplify compliance and monitoring obligations of the sponsor. One commenter, however, expressed concern that the definition of single vertical security could be read as though the security could have different percentage interests in each class and requested that the definition be amended to clarify that the specified percentages must result in the fair value of each interest in each such class being identical.

The agencies received several comments regarding the proposed method by which a sponsor may satisfy its risk retention requirement by holding an eligible horizontal residual interest. One commenter sought clarification as to whether advance rates and overcollateralization, equipment residual values, reserve accounts and third-party credit enhancement would constitute eligible horizontal residual interests. Another commenter sought clarification as to whether the eligible horizontal residual interest would be required to have the most subordinated claim to principal collections.[56] Further, one commenter expressed concern that the eligible horizontal residual interest option would create a conflict of interest between the sponsor and the holders of the other classes of securities, to the extent that the servicer would have control over decisions that could optimize the value of the interest at the expense of other tranches.

Regarding the horizontal cash reserve account, one commenter requested that the final rule permit a broader range of investments to align with market practice regarding standard investments used for funds held in collection, reserve and spread accounts. Another commenter requested that the final rule permit funds from eligible horizontal cash reserve accounts to be used to pay critical expenses, so long as such expense payments are made for specified priorities and are disclosed to investors. The commenter further proposed that no disclosure or calculations should be required for such payments that are senior to amounts owed to holders of third-party ABS interests or that are made to transaction parties unaffiliated with the securitizer.

The agencies invited comment on whether the rule should require a minimum proportion of risk retention held by a sponsor under the standard risk retention option to be composed of a vertical component or a horizontal component. Further, the agencies invited comment on whether a sponsor should be required to hold a higher percentage of risk retention if the sponsor retains only an eligible vertical interest or very little horizontal interest. The agencies did not receive any comments in favor of these options. One commenter expressed opposition to any requirement for a minimum vertical or horizontal component, claiming that such a requirement would increase compliance costs and increase the risk that sponsors would, as a result of accounting standards, have to consolidate securitization entities into their financial statements. In addition, two commenters expressed opposition to any higher risk retention requirement for sponsors retaining only a vertical interest.

Several commenters expressed opinions on the effect that the proposed standard risk retention option would have on decisions by sponsors regarding whether they are obligated by accounting standards to consolidate a securitization vehicle into their financial statements. Two commenters asserted that, because of the flexibility of the proposed standard risk retention option, in and of itself, the option would not cause a sponsor to have to consolidate its securitization vehicles. One of these commenters observed that case-by-case analyses would be required and that the likelihood of consolidation would increase as a sponsor retains a greater portion of its required interest as a horizontal interest. Another commenter asserted that, if potential investors require the sponsor to hold a horizontal rather than a vertical interest, or a combination, the consolidation risk will increase. This same commenter stated that forthcoming updated guidance from the Financial Accounting Standards Board may modify the way sponsors analyze their consolidation requirements. One commenter asserted that consolidation concerns may cause broker-dealers to limit their secondary market support, with respect to certain affiliate transactions, for the duration of the risk retention period and that such decisions may have an effect on secondary market liquidity. As a way of reducing consolidation risk, one commenter stated that securitization agreements should be required to give securitization trusts the right to claim 5 percent of losses from securitizers as they occur. Such losses, the commenter asserted, should be held as contingent liabilities on securitizers' balance sheets, against which reserves would need to be held.

The agencies have carefully considered comments on the reproposed structure of the standard risk retention option and, for the reasons discussed below and in the reproposal, have decided to adopt the approach as set forth in the revised proposal with some modifications. However, in the final rule the agencies are adopting several changes to the manner in which risk retention must be measured and are eliminating the restrictions on cash flow to the eligible horizontal residual interest. These changes are discussed in Part III.B.1 of this Supplementary Information.

Consistent with the reproposal, the final rule allows a sponsor to satisfy its risk retention obligation by retaining an eligible vertical interest, an eligible horizontal residual interest, or any combination thereof, as long as the percentage of the eligible vertical interest claimed as retention under the rule, when added to the percentage of the fair value of the eligible horizontal residual interest claimed as retention for purposes of the rule equals no less than five. The final rule 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, nor does the final rule require sponsors to hold a higher percentage of risk retention if the sponsor retains only an eligible vertical interest. The agencies added language to the final rule clarifying that the requisite percentage of eligible vertical interest, eligible horizontal residual interest, or combination thereof retained by the sponsor must be determined as of the closing date of the securitization transaction.[57]

[56] In response to a similar comment, the agencies confirm that a structure under which the interest is at the bottom of the priority of payments provisions, or last in line for payment, would satisfy this requirement whether or not the interest is ''legally'' subordinated.

[57] For example, a sponsor electing to hold risk retention in the form of a combined horizontal and vertical interest could determine the minimum amount required to be retained pursuant to the rule by determining the percentage of fair value represented by the sponsor's eligible horizontal residual interest, and then supplementing that amount with a vertical interest of a sufficient percentage so that the sum of the two percentage numbers equals five. To illustrate: If a sponsor holds an eligible horizontal residual interest with a fair value of 3.25 percent of the fair value of all the ABS interests in the issuing entity, the sponsor must also hold (at a minimum) a vertical interest equal to 1.75 percent of each class of ABS interests in the issuing entity. Alternatively, the sponsor may retain a single vertical security representing 1.75

The final rule allows a sponsor to satisfy its risk retention obligation under the vertical option by retaining a portion of each class of the ABS interests issued in the transaction or a single vertical security which represents an interest in each class of the ABS interests issued in the securitization. The rule specifies the minimum retention to be held by a sponsor. As such, the fact that provisions such as the definition of eligible vertical interest and single vertical security require the sponsor to hold the same proportion of or interest in each class of ABS interests does not preclude the sponsor from holding different proportions of or in each class. However, it does preclude the sponsor from claiming risk retention credit under the rule for any proportional interest in a class that is not the same across all classes. For example, a sponsor which holds a vertical interest of 5 percent of the most junior class and 3 percent of all other classes issued by the entity can only claim credit for a 3 percent vertical interest.

A sponsor choosing to satisfy its retention obligation solely through the retention of an interest in each class of ABS interest issued will be required to retain at least 5 percent of each class of ABS interests issued as part of the securitization transaction. A sponsor using this approach will be required to retain at least 5 percent of each class of ABS interests issued in the securitization transaction regardless of the nature of the class of ABS interests (*e.g.,* senior or subordinated) and regardless of whether the class of interests has a face or par value, was issued in certificated form, or was sold to unaffiliated investors. For example, if four classes of ABS interests are issued by an issuing entity as part of a securitization—a senior-rated class, a subordinated class, an interest-only class, and a residual interest—a sponsor using this approach with respect to the transaction will have to retain at least 5 percent of each such class or interest. If a class of interests has no face value, the sponsor will have to hold an interest in 5 percent of the cash flows paid on that class.

If a sponsor opts to satisfy its risk retention requirement solely by retaining a single vertical security, that ABS interest must entitle the holder to 5 percent of the cash flows paid on each class of ABS interests in the issuing entity (other than such single vertical security). This will provide sponsors an option that is simpler than carrying multiple securities representing a percentage share of every series, tranche, and class issued by the issuing entity, each of which might need to be valued by the sponsor on its financial statements every financial reporting period. The single vertical security option will provide the sponsor with the same principal and interest payments (and losses) as a 5 percent ownership of each series, class, or tranche of the securitization, in the form of one security to be held on the sponsor's books.

Also consistent with the revised proposal, the final rule allows a sponsor to satisfy its risk retention obligation exclusively through the horizontal option by retaining a first loss eligible horizontal residual interest in the issuing entity in an amount equal to no less than 5 percent of the fair value of all ABS interests in the issuing entity that are issued as part of the securitization transaction. The eligible horizontal residual interest may consist of either a single class or multiple classes in the issuing entity, provided that each interest qualifies, individually or in the aggregate, as an eligible horizontal residual interest.[58] In the case of multiple classes, this requirement will mean that the classes must be in consecutive order based on subordination level. For example, if there are three levels of subordinated classes and the two most subordinated classes have a combined fair value equal to 5 percent of all ABS interests, the sponsor will be required to retain these two most subordinated classes if it is going to satisfy its risk retention obligation by holding only eligible horizontal residual interests.

In lieu of holding all or part of its risk retention in the form of an eligible horizontal residual interest, the final rule will allow a sponsor to cause to be established and funded, in cash, an eligible horizontal cash reserve account, at closing, in an amount equal to the same dollar amount (or corresponding amount in the foreign currency in which the ABS interests are issued, as applicable) as would be required if the sponsor held an eligible horizontal residual interest. As described in the reproposal, the eligible horizontal cash reserve account will have to be held by a trustee (or person performing functions similar to a trustee) for the benefit of the issuing entity. Consistent with the reproposal, the final rule includes several important restrictions and limitations on the eligible horizontal cash reserve account to ensure that a sponsor that establishes an eligible horizontal cash reserve account will be exposed to the same amount and type of credit risk on the securitized assets as would be the case if the sponsor held an eligible horizontal residual interest. The intention of these restrictions is to ensure amounts in the account would be available to absorb losses to the same extent as an eligible horizontal residual interest. Therefore, investments of funds in the account and uses of the account are limited. The agencies are not following commenters' suggestion to broaden the range of permissible investments of funds in the horizontal cash reserve account because that could undermine the capacity of the account to absorb losses as they occur to the same extent as an eligible horizontal residual interest. Any use of funds other than loss coverage could result in fewer funds to absorb losses later. The types of permissible investments likewise are restricted to cash and cash equivalents in order to ensure that the account will not incur investment losses and reduce the capacity of the account to absorb losses of the securitization transaction. The agencies view ''cash equivalents'' to mean high-quality, highly-liquid short-term investments the maturity of which corresponds to the securitization's expected maturity or potential need for funds and that are denominated in a currency that corresponds to either the securitized assets or the ABS interests. Depending on the specific funding needs of a particular securitization, ''cash equivalents'' might include deposits insured by the FDIC, certificates of deposit issued by a regulated U.S. financial institution, obligations backed by the full faith and credit of the United States, investments in registered money market funds, and commercial paper. For securitization transactions whose securitized assets or ABS interests are denominated in a foreign currency, cash equivalents would include cash equivalents denominated in the foreign currency. The agencies believe that the permitted investment options provide sufficient flexibility to sponsors that choose to create an eligible horizontal cash reserve account, while ensuring that such sponsors will be exposed to the same amount and type of credit risk as would be the case if the sponsor held an eligible horizontal residual interest.

In response to commenter concerns, the agencies believe that it would not violate the requirements of the eligible horizontal cash reserve account if as a result of a shortfall in the available cash

percent of the cash flows paid on each class of ABS interests in the issuing entity (other than the single vertical security itself). The rule does not prohibit the sponsor from retaining additional amounts of horizontal interests, vertical interests, or both.

[58] *See* section 2 of the final rule (definition of ''eligible horizontal residual interest'').

flow, critical expenses of the trust unrelated to credit risk, such as litigation expenses or trustee or servicer expenses, are paid from an eligible horizontal cash reserve account, so long as such payments, in the absence of available funds in the eligible horizontal cash reserve account, would be paid prior to any payments to holders of ABS interests and such payments are made to parties that are not affiliated with the sponsor.

The agencies believe the standard risk retention option, as adopted, provides sponsors with flexibility in choosing how to structure their retention of credit risk in a manner that is compatible with current practices in the securitization markets. For example, in securitization transactions where the sponsor would typically retain less than 5 percent of an eligible horizontal residual interest, the standard risk retention option will permit the sponsor to hold the balance of the risk retention as a vertical interest. Each sponsor will have to separately analyze whether the particular option the sponsor selects under the rule requires the sponsor to consolidate the assets and liabilities of a securitization vehicle onto its own balance sheet for accounting purposes. The rule itself does not provide guidance on performing the consolidation analysis, either in support of deconsolidation or in requirement of consolidation.

b. Risk Retention Measurement and Disclosures

As explained in the revised proposal, to provide greater clarity for the measurement of risk retention and to help prevent sponsors from structuring around their risk retention requirement by negating or reducing the economic exposure they are required to maintain, the agencies proposed to require sponsors to measure their risk retention requirement using fair valuation methodologies acceptable under GAAP.[59]

Several commenters supported the proposed requirement that sponsors measure their risk retention requirement using fair value. These commenters expressed the view that the use of fair value would be a more prudent approach than using face value and would be consistent with market practice. Other commenters, however, expressed general concern with the proposed method by which sponsors would be required to measure their risk retention. One commenter asserted that using fair value instead of face value would require sponsors to hold higher risk retention levels and attract additional investor capital, leading to higher borrowing costs. Two commenters explained that many sponsors who consolidate their issuing entities or keep their securitizations on their balance sheets do not currently utilize fair value calculations, and that requiring such sponsors to measure their risk retention with fair value would create significant burden and expense.

Commenters expressed several specific accounting concerns regarding the use of fair value to measure risk retention. Two commenters asserted that calculation of fair value under GAAP is not designed to provide a definitive value, but a range of values. In this regard, they expressed concerns about how the requirements could be met if a sponsor calculates multiple possible fair values. One commenter asserted that requiring sponsors to determine fair value in accordance with GAAP would be burdensome for securitization transactions where the sponsor (or other retaining entity) is established outside the United States, giving rise to additional work and costs. For such transactions, the commenter urged the agencies to allow sponsors to measure fair value using local (non-U.S.) GAAP or International Financial Reporting Standards (IFRS). One commenter asserted that GAAP does not prescribe use of a single valuation technique, but allows entities to use various techniques, including market, income and cost approaches. The commenter stated, however, that the reproposal implied that sponsors would be limited to specific valuation techniques and requested that the final rule clarify that sponsors are not so restricted. The commenter also asserted that the reproposal equated intrinsic value with fair value, which are distinct standards of value. In this regard, the commenter stated that reference to intrinsic value should either be excluded from the final rule or the agencies should clarify that intrinsic and fair value are two separate concepts.

The agencies invited comment in the reproposal on whether accountants would be asked to perform agreed upon procedures reports related to measurement of the fair value of sponsors' retained ABS interests. One commenter responded that such requests would be unlikely and requested that the agencies not mandate agreed upon procedures in the final rule.

One commenter stated that sponsors should be permitted to measure their risk retention requirement by using either fair value or securitization value (the value specified in the operative documents for the securitization transaction, subject to certain limitations) methodology. The commenter stated that securitization value is familiar to sponsors and investors, and permitting its use would accommodate a range of current industry practices. The commenter also stated that securitization value would be easier to compute than fair value.

One commenter asserted that any required risk retention amount for ABCP conduits should be calculated by reference to the principal balance, and not the fair value, of the ABS interests and asserted that using fair value will be difficult, expensive and unnecessary, especially given the revolving nature of the asset pool. Commenters also requested clarification as to whether, when they are calculating the fair value with respect to revolving pool of assets, they can make static pool assumptions.

Having considered the comments described above, the agencies are adopting a fair value framework substantially similar to the reproposal for calculating eligible horizontal residual interests in the final rule. As discussed in the reproposal, this measurement uses methods consistent with valuation methodologies familiar to market participants and provides a consistent framework for calculating residual risk retention across different securitization transactions. It also takes into account various economic factors that may affect the securitization transaction, which should aid investors in assessing the degree to which a sponsor is exposed to the risk of the securitized assets. As discussed below, in response to commenters the agencies are not adopting the proposed fair value measurement requirement for eligible vertical interests because such measurement is not necessary to ensure that the sponsor has retained 5 percent of the credit risk of the ABS interests issued.

Consistent with the reproposal, the agencies are not modifying the final rule to allow for calculation of fair value using the fair value measurement framework under local GAAP or IFRS for securitization transactions where the sponsor is established outside the United States. The agencies believe that, as of the time the final rule is adopted, these alternative valuation frameworks and GAAP have common requirements for measuring fair value, which should minimize the burden to sponsors established outside the United States of measuring fair value using the GAAP framework. The agencies believe that

[59] *Cf.* Financial Accounting Standards Board, Accounting Standards Codification Topic 820—Fair Value Measurement.

the benefits of being able to easily compare the fair value of risk retention in two separate issuances of ABS interests regardless of where the sponsors are established outweigh any minimal burden imposed by the requirement to use GAAP fair value.

In response to commenters' concerns about the burden of repeatedly calculating fair value for a constantly changing pool of securitized assets, the agencies believe that no change to the reproposed rule is required. Under the final rule, only those securitization transactions in which the issuing entity issues ABS interests more than once need to calculate the fair value of the eligible horizontal residual interest multiple times. The final rule provides specific risk retention options for most sponsors of securitizations that issue multiple series of ABS interests, including revolving pool securitizations, tender option bond programs and ABCP conduits. The agencies also note that those securitization structures which issue ABS interests on a frequent basis, primarily ABCP conduits and tender option bond programs, typically issue short-term securities for which the fair value calculation should be less complex. The agencies are clarifying that, to the extent that a sponsor uses a valuation methodology that calculates fair value based on the pool of securitized assets as of a certain date, the sponsor of a securitization of a revolving or dynamic pool of securitized assets would be able to calculate the fair value of the ABS interests using data with respect to the securitized assets as of a cut-off date or similar date, as described below, which the agencies believe should alleviate some of the concerns expressed by commenters about the burden of repeatedly calculating the fair value of the ABS interests issued. The agencies believe that this approach appropriately balances commenters' concerns with the agencies' policy goals of providing appropriate transparency into a sponsor's calculation of the fair value of ABS interests under the final rule.

Additionally, the agencies have concerns that the alternative suggested by commenters of calculating fair value no more than once per month would create unintended consequences. For instance, the calculation of fair value of ABS interests up to a month before the issuance of those ABS interests or up to a month after the issuance of those ABS interests could result in disclosure to investors based on unreliable assumptions about pricing and the expected volume of ABS interests to be issued and possibly the issuance of ABS interests in violation of the sponsor's risk retention requirements.

Under the final rule, to the extent a sponsor uses a valuation methodology that calculates fair value based on the pool of securitized assets as of a certain date, a sponsor would be permitted to use a cut-off date for establishing the composition and characteristics of the pool of securitized assets collateralizing the asset-backed securities (or similar date) that is not more than 60 days prior to the date of first use of the fair value calculation with investors, except in the case of a securitization transaction that makes distributions to investors on a quarterly or less frequent basis, in which case the sponsor may use a cut-off date or similar date not more than 135 days prior to the date of first use of the fair value calculation with investors.[60] The final rule requires that disclosures to investors be based on information about the asset pool (such as the characteristics of and assumptions regarding the pool that will be used to determine fair value) as of the cut-off date or similar date specified by the sponsor. The actual balance of the securitized assets (and the calculation of fair value) may include anticipated additions to and removals of assets that the sponsor will make between the cut-off date or similar date and the closing date. For purposes of the fair value calculation, the ABS interests must include all ABS interests issued prior to, and expected to be issued in, the pending offering of ABS interests.[61] The agencies believe this will accommodate the reporting described by commenters and the evaluation of pool assets suggested by commenters with respect to fair value calculations. The agencies recognize that not all securitization transactions update information about securitized assets on a monthly basis. The final rule permits sponsors to rely on information about the securitized assets based on a date not more than 135 days prior to the date of first use with investors for subsequent issuances of ABS interests by the same issuing entity with the same sponsor for which the securitization transaction distributes amounts to investors on a quarterly or less frequent basis.[62]

As discussed in the reproposal, fair value is a measurement framework that requires an extensive use of judgment for certain types of financial instruments, for which significant unobservable inputs are necessary to determine their fair value. To provide transparency to investors, regulators and others on how the sponsor calculates fair value in order to determine its eligible horizontal residual interest, and to ensure that this calculation adequately reflects the amount of a sponsor's economic ''skin in the game,'' the agencies proposed to require disclosure of the sponsor's fair value methodology and all significant inputs used to measure its eligible horizontal residual interest. Under the reproposal, sponsors that elected to utilize the horizontal risk retention option would have been required to disclose the reference data set or other historical information used to develop the key inputs and assumptions intended to meaningfully inform third parties of the reasonableness of the key cash flow assumptions underlying the measure of fair value. Such key assumptions could include default, prepayment, and recovery. As discussed in the reproposal, the agencies believed that these valuation inputs would help investors assess whether the fair value measure used by the sponsor to determine the amount of its risk retention is comparable to investors' expectations.

Specifically, with respect to eligible horizontal residual interests, the reproposal would have required that sponsors provide (or cause to be provided) to potential investors a reasonable time prior to the sale of ABS interests in the issuing entity and, upon request, to the Commission and its appropriate Federal banking agency (if any) disclosure of:

- The fair value (expressed as a percentage of the fair value of all ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS interests are issued, as applicable)) of the eligible horizontal residual interest that would be retained (or was retained) by the sponsor at closing, and the fair value (expressed as a percentage of the fair value of all ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS interests are issued, as applicable)) of

[60] The agencies expect that a sponsor will include disclosure about the cut-off date as an aspect of the fair valuation methodology it used.

[61] The sponsor may include adjustments to the balance of ABS interests that are expected to occur in the ordinary course of events, such as scheduled principal reductions and planned issuances expected to occur after the pending offering of ABS interests.

[62] The 135-day period provides sponsors with approximately 45 days after the end of any quarter in which to provide the required information to investors if the issuing entity makes distributions to investors no more frequently than quarterly. This period parallels timeframes for prospectus and static pool information under Regulation AB. *See* Items 1104 and 1105 of Regulation AB.

the eligible horizontal residual interest required to be retained by the sponsor in connection with the securitization transaction;

- A description of the material terms of the eligible horizontal residual interest to be retained by the sponsor;
- A description of the methodology used to calculate the fair value of all classes of ABS interests;
- The key inputs and assumptions used in measuring the total fair value of all classes of ABS interests and the fair value of the eligible horizontal residual interest retained by the sponsor (including the range of information considered in arriving at such key inputs and assumptions and an indication of the weight ascribed thereto) and the sponsor's technique(s) to derive the key inputs; and
- The historical data that would enable investors and other stakeholders to assess the reasonableness of the key cash flow assumptions underlying the fair value of the eligible horizontal residual interest. Examples of key cash flow assumptions may include default, prepayment, and recovery.

The agencies received significant comment on the proposed disclosure requirements with respect to the eligible horizontal residual interest, particularly regarding the proposed timing of disclosures and fair value calculations. Commenters expressed a number of concerns regarding the pre-sale disclosure requirement. Several commenters stated that there is an inherent conflict between the proposed requirement that fair value disclosures be made a reasonable time prior to the sale of ABS interests and the requirement that fair value be determined as of the day on which the price of the ABS interests to be sold to third parties is determined. Further, several commenters asserted that the most objective and accurate way to calculate fair value is to base the valuation on an observable market price, but this option is unavailable to sponsors in advance of pricing. In order to comply with the pre-sale disclosure requirement, they contended that sponsors would be required to make material assumptions, based on less reliable secondary sources, regarding interest, default, recovery and prepayment rates, as well as timing of reinvestments for revolving pools. Doing so, they asserted, would often result in differences between the pre-sale and final fair value and would confuse investors.

One commenter raised a concern about the proposed requirement that fair value be calculated as of the day on which the price of ABS interests sold to third-party investors is determined. The commenter, asserting that pricing for different classes in single-securitization transactions often occurs on different days, urged the agencies to clarify that the determination of fair value should be done for all classes of asset-backed securities at a single time after a specified percentage threshold of classes of asset-backed securities have priced.

As a proposed solution to the timing concerns summarized above, two commenters recommended that the final rule should require fair value determinations to be made after pricing but before closing of the transaction. The commenters stated that this would allow sponsors to more accurately determine fair value based on pricing of the securitization transaction. The commenters further stated that sponsors could still be required to disclose the expected form of risk retention prior to sale, but they should only be required to determine the fair value of those interests shortly after pricing.

In addition to timing concerns, many commenters expressed concerns about the proposed requirement that sponsors disclose the key inputs and assumptions used in measuring fair value and the sponsor's technique(s) used to derive the key inputs. Two commenters specifically stated that requiring such disclosures may mislead investors by making such inputs and assumptions seem authoritative. Further, several commenters asserted that the proposal would require sponsors to disclose information that is proprietary, highly confidential and commercially sensitive. Such information, they contended, could be used by third parties to the competitive disadvantage of the sponsor. One commenter raised specific concerns regarding the disclosure of reference data sets, noting that disclosure of such information could allow the reverse-engineering of proprietary models.

While two commenters expressed support for the reproposal's requirements that sponsors disclose the various components that were used to make fair value determinations, many others requested significant modifications to the disclosure requirements. Several commenters asserted that the rule should only require a simple disclosure to the effect that risk retention has been measured as required by the final rule. Several commenters stated that sponsors should only be required to make disclosures to the Commission and banking agencies, rather than to investors. Two such commenters proposed that issuers should be required to retain the documentation about assumptions and methodology used in calculating their risk retention obligations for a specified period of time and make such information available for inspection by the Commission and banking agencies, if requested. Further, one commenter proposed that sponsors should only be required to provide the agencies with a post-securitization fair value report within a reasonable time after the issue date.

Significant concern was raised regarding potential liability and litigation that commenters stated may result when fair value projections, assumptions and calculations disclosed to investors turn out to be incorrect. A few commenters expressed the view that liability risk would be particularly high from incorrect loss projections. Several commenters asserted that litigation risks may undermine the horizontal option by convincing many sponsors to rely instead on the vertical option. Another commenter asserted such concerns may convince sponsors to hold risk retention closer to the 5 percent minimum than they otherwise would because it is easier to demonstrate that a projected 5 percent risk retention would be accomplished than it would be for a larger percentage. Several commenters urged the agencies to provide a safe harbor from liability for all fair value calculations, which would protect sponsors as long as the methodology and assumptions used to make such calculations are reasonable and made in good faith.

Two commenters proposed that for simple structures, sponsors should not be required to make fair value determinations or related disclosures, nor should the cash flow restriction (as described below) apply. The commenters requested that such relief be provided to structures with the following characteristics: (1) The principal amount of the ABS interests sold to third parties is less than 95 percent of the principal amount of the securitized assets (and, in the case of pre-funded transactions, any cash held in a pre-funded account); (2) the weighted average interest rate (for leases, the implicit interest rate used to calculate the lease payments) on the securitized assets (or the discount rate in the case of a securitization value calculation) is not expected to be less than the time-weighted average interest rate on the ABS interests sold to third parties (for revolving and pre-funded transactions, this condition would be satisfied upon the completion of each addition of additional assets); (3) all of the ABS interests sold to third parties are traditional interest-bearing debt securities; and (4) the residual interest

retained by the sponsor or other holder of a retained interest otherwise meets the requirements of an eligible horizontal residual interest.

The agencies have carefully considered the concerns of commenters with respect to the proposed disclosure requirements related to the fair value calculation of eligible horizontal residual interests. The agencies continue to believe that it is important to the functioning of the final rule to ensure that investors and the markets, as well as regulators, are provided with key information about the methodology and assumptions used by sponsors under the final rule to calculate the amount of their eligible horizontal residual interests using the fair value measurement framework under GAAP. As the agencies have previously observed, fair value is a measurement framework that for certain types of instruments requires an extensive use of judgment. In situations where significant unobservable inputs are used to determine fair value, disclosures of those assumptions are necessary to enable investors to effectively evaluate the fair value calculation. Therefore, the agencies are generally retaining the proposed fair value disclosure requirements with some modifications in response to commenter concerns, as further discussed below.

The agencies have considered the concerns raised by commenters about the potential conflict between pre-sale disclosure and timing of the fair value measurement. The agencies believe that it is important that investors be provided with information that would allow them to better evaluate how sponsors will measure the fair value of the eligible horizontal residual interest to be retained and that such information be provided prior to the investor's investment decision. The final rule continues to require certain fair value disclosures to be provided to investors a reasonable period of time prior to the sale of an asset-backed security. Nonetheless, the agencies recognize that any valuation information given prior to sale may often be preliminary. Therefore, the agencies have revised the final rule to address these concerns. The final rule allows sponsors, for disclosures provided prior to sale, to disclose the sponsor's 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. Under the final rule, a sponsor may provide a range of fair values for the eligible horizontal residual interest only if the specific prices, sizes or rates of interest of each tranche of the securitization are not available. Additionally, this range of fair values must be based on a range of bona fide estimates or specified prices, sizes, or rates of interest of each tranche of the securitization. The agencies note that in practice this will allow the sponsor to provide fair value disclosures based on the pricing guidance traditionally provided to investors prior to sale.[63] The sponsor must also disclose the method by which it determined any range of bona fide estimates or specified prices, tranche sizes or rates of interest.

The final rule also requires the sponsor to provide to investors a reasonable time after the closing of the securitization transaction the actual fair value measurement of the ABS interests and the eligible horizontal residual interest that the sponsor is required to retain, expressed as a dollar amount and percentage. This post-closing disclosure must be based on actual sale prices and finalized tranche sizes and corresponding interest rates at the closing of the securitization transaction.

The agencies continue to believe that the fair value of the eligible horizontal residual interest held by the sponsor as calculated post-closing must not be less than the amount required under the rule to be held by the sponsor. Although commenters expressed some concern about possible adjustments to the transaction occurring prior to closing that may impact the fair value of the eligible horizontal residual interest, the agencies expect that, if necessary, as part of the pricing process, the sponsor will make adjustments to tranche sizes, increase the percentage of vertical interest retained by the sponsor, or otherwise take actions to ensure that the actual fair value of the eligible horizontal residual interest held by the sponsor satisfies the sponsor's risk retention obligations.

The sponsor also must disclose at that time any material differences between the inputs and assumptions that had been disclosed by the sponsor to potential investors prior to sale (as required by the final rule) and the actual methodology, inputs, and assumptions used by the sponsor to measure fair value for purposes of the final rule. The agencies believe that this bifurcated approach to the timing of disclosures, as well as clarification that the pre-closing disclosures are based on a sponsor's range of bona fide estimates or specified prices, tranche sizes or rates of interest with relation to the fair value measurement of the ABS interests, should effectively balance the benefits investors and others receive from the disclosures against the concerns of sponsors.

The final rule generally retains the proposed requirement that the sponsor disclose a description of the methodology it uses to measure the fair value of the ABS interests and its eligible horizontal residual interest. For example, under the final rule sponsors are required to disclose the valuation methodology the sponsor used to determine fair value, such as discounted cash flow analysis, comparable market data, vendor pricing, or internal-model based analysis.

As discussed above, a number of commenters expressed concern about heightened legal risk and other risks due to the proposed requirement to disclose quantitative information about key inputs and assumptions, and various commenters requested that the agencies not require these disclosures to be provided to investors. The agencies continue to believe that disclosure of descriptive information with respect to key inputs and assumptions used in fair value measurement is important for helping investors to assess whether the fair value measure used by the sponsor to determine its eligible horizontal residual interest is comparable to market expectations. However, in response to commenter concerns, the agencies are modifying these requirements to take into account the preliminary and estimated nature of pricing information that may need to be used to calculate fair value prior to the sale of an asset-backed security.

The agencies believe that the disclosure required by the accounting standards that gives investors and others an understanding of how companies measure fair value is also pertinent to investors' and regulators' understanding how sponsors calculate the fair value of their eligible horizontal residual interests under the rule. Therefore, the final rule requires that the sponsor disclose, at a minimum, a description of all the inputs and assumptions it uses to calculate the fair value of the ABS interests and its eligible horizontal residual interest, including, as applicable and relevant to the calculation, disclosures on discount rates, loss given default (recovery rates), prepayment rates, default rates, the lag time between default and recovery, and

[63] The agencies expect that the range of bona fide estimates or specified prices, tranche sizes or rates of interest should be reasonably narrow, reflecting then current market conditions and the relationship between the sponsor's range of bona fide estimates or specified prices, tranche sizes or rates of interest and the historical data or other information used to derive the range of bona fide estimates or specified prices, tranche sizes or rates of interest. The agencies also expect that in most instances the range of assumed sale prices and tranche sizes will correspond closely to any pricing guidance provided to potential purchasers prior to sale.

the basis of forward interest rates used. The agencies have not prescribed the exact format of the description of key inputs and assumptions that sponsors are required to provide under the final rule. The agencies expect that the format of the required description will be tailored to the key inputs and assumptions and the reference data sets or other historical information underlying those key inputs and assumptions being described. The agencies believe that the descriptions may be disclosed in quantitative or narrative form or in a graphical or tabular format, as appropriate.

The sponsor is required to provide descriptions of all inputs and assumptions that either could have a material impact on the fair value calculation or would be material to a prospective investor's ability to evaluate the sponsor's fair value calculations. The required description of the material terms of the eligible horizontal residual interest to be retained by the sponsor should include a description of the rate of interest and other payment terms, including contractually pre-determined events that would reasonably be likely to result in a materially disproportionate payment of principal to the holder of the residual interest, as well as any reductions in overcollateralization. To the extent the required disclosure includes a description of a curve or curves in connection with the sponsor's fair value calculations, the sponsor must disclose a description of the methodology that was used to derive each curve and a description of any aspects or features of each curve that could materially impact the fair value calculation or the ability of a prospective investor to evaluate the sponsor's fair value calculation. The agencies expect that a description of the material aspects of a curve would include any aspects of the curve that could be reasonably expected to have a material impact on the timing and amounts of distributions expected to be paid to the holder of the eligible horizontal residual interest (or released from the eligible horizontal cash reserve account).

For example, if the sponsor uses curves with respect to certain key inputs and assumptions in the fair value calculations, the agencies expect that the description of those key inputs and assumptions would not assume straight lines (*e.g.,* zero-loss assumptions). As a further example, if the sponsor uses a prepayment curve to calculate the fair value of the ABS interests and its eligible horizontal residual interest for a residential mortgage securitization transaction, the disclosure might indicate that estimated annual prepayments are expected to range from X percent to Y percent, notably increasing after 36 months of amortization and peaking after 84 months of amortization. Furthermore, to the extent the inputs and assumptions are observable and based on market prices or other public information, the sponsor should disclose those inputs and assumptions or their source in order to fulfill its requirement under the final rule.

The post-closing fair value disclosure, which is required a reasonable time after the closing, obligates the sponsor to disclose any material differences between the range of bona fide estimates or specified prices, tranche sizes or rates of interests disclosed previously, as the case may be, and the actual prices, tranche sizes or rates of interest used by the sponsor in its calculation of the fair value under the rule for the ABS interests sold at closing. This permits sponsors to use the actual pricing of the ABS interests as the basis for their final disclosure requirement, which addresses certain of the concerns raised by commenters discussed above.

The agencies believe that the revisions made to the rule appropriately balance the agencies' concerns that fair value disclosure requirements adequately allow an investor to analyze the amount of a sponsor's economic ''skin in the game'' with commenters' concerns about the level of detail required by the fair value disclosure requirements.

The agencies observe that financial companies commonly provide company or portfolio-level disclosure in their financial statements about estimated ranges (and weighted averages) for certain inputs, such as interest rates and prepayment rates. Furthermore, sponsors of recent publicly-offered securitization transactions have disclosed modeling assumptions for prepayment rates based on the characteristics of securitized loans. The agencies believe that the disclosures required under the final rule are similar in nature, albeit more detailed, than these public disclosures already being made for financial reporting and similar purposes. The agencies understand that some types of inputs and assumptions have generally not been publicly disclosed, and that most sponsors have disclosed certain inputs at the balance sheet or portfolio level for different types of assets, with varying degrees of granularity that have generally not included disclosures for individual transactions. However, the agencies observe that some of the concerns that commenters have raised about potential liability for disclosure of inputs and assumptions at the transactional level could also be pertinent at the portfolio level if the inputs and assumptions were later proved incorrect. Furthermore, the agencies believe that the modifications to the disclosure requirement that permit the sponsor to disclose a range of fair values based on assumptions about pricing, appropriately balances commenters' concerns with the agencies' policy goals of providing appropriate transparency into a sponsor's calculation of the fair value of ABS interests and eligible horizontal residual interest under the final rule. In response to commenters' concerns about the proposed requirement to disclose the reference data set or other historical information used to develop the key inputs and assumptions used in the fair value measurement of the ABS interests, the agencies have modified significantly that requirement in the final rule. The agencies understand there may be significant legal concerns with disclosing this data, including the proprietary nature and value of the data and contractual restrictions with respect to disclosure when the data is provided by third parties. The agencies believe that investors may in many cases independently obtain representative data sets for evaluating the ABS interests offered for purposes of evaluating the sponsor's fair value measurement, including the disclosures on the sponsor's inputs and assumptions required by the final rule and described above.

The final rule requires that the sponsor provide a summary description of the reference data set or other historical information used to develop the key inputs and assumptions used in the sponsor's calculation of the fair value of the ABS interests, including loss given default and default rates. This disclosure should meaningfully inform third parties of the reasonableness of the key cash flow assumptions underlying the sponsor's measurement of fair value. Relevant information may include the number of data points, the time period covered by the data set, the identity of the party that collected the data, the purpose for which the data was collected and, if the data is publicly available, how the data may be accessed. The agencies believe that this represents an appropriate balance between the information required for an investor to evaluate the sponsor's fair value disclosure and commenter's concerns about the disclosure of the reference data set or other historical information. In response to commenters' requests that the agencies provide a safe

harbor from liability for all fair value calculations, as long as the methodology and assumptions used to make such calculations are reasonable and made in good faith, the agencies do not believe a new safe harbor is necessary. The final rule does not alter any existing antifraud liability provisions of the Federal securities laws. Furthermore, sponsors may provide additional disclosure to take advantage of the existing safe harbor for forward-looking statements under section 27A of the Securities Act,[64] if applicable, and the ''bespeaks caution'' defense developed through case law.[65]

To this end, the sponsor should consider carefully the disclosure requirements under the Federal securities laws. The sponsor should be cognizant of surrounding disclosure and should determine if the disclosure of such fair value methodology and related assumptions requires additional statements or information.[66]

To the extent the assumptions made in connection with the methodology used to measure fair value are not entirely consistent with other disclosure regarding the securitization structure and the transaction parties, the sponsor may need to include additional statements or information that reduce the potential confusion among investors. Alternatively, to the extent allowed under the fair value measurement framework under GAAP, a sponsor could use a methodology and assumptions that are more consistent with the sponsor's other disclosures regarding the securitization structure and the transaction parties.

The agencies did not provide an option for ''simple structures'' based on the face value of the securitized assets and the face value of the ABS interests. The agencies believe that the face value of both the securitized assets and the face value of the ABS interests do not necessarily reflect the actual value of the securitized assets or the ABS interests, respectively. For certain assets such as leases, the ''face value'' of the underlying assets is a number calculated solely for purposes of the securitization transaction and the calculation involves many of the inputs and assumptions discussed above in relation to fair value. The face value of certain ABS interests such as the CMBS B-piece does not reflect the substantial discount to face value at which such ABS interests are often sold to investors. As the face value of both the securitized assets and the face value of the ABS interests can materially differ from their relative value and cost to the sponsor, the agencies do not believe that a credit risk retention option based solely on a comparison of the face value of the underlying assets and the face value of the ABS interests would provide meaningful risk retention consistent with the goals and intent of section 15G.[67]

In addition to the measurement and disclosure requirements applicable to eligible horizontal residual interests, the reproposal would have required sponsors holding their risk retention through eligible vertical interests to measure such interests using fair value and to comply with certain disclosure requirements. With respect to the vertical option, the reproposal would have required that sponsors provide (or cause to be provided) to potential investors a reasonable time prior to the sale of ABS interests in the issuing entity and, upon request, to the Commission and its appropriate Federal banking agency (if any) disclosure of:

- Whether any retained vertical interest is retained as a single vertical security or as separate proportional interests in each ABS interest;
- Each class of ABS interests in the issuing entity underlying the single vertical security at the closing of the securitization transaction and the percentage of each class of ABS interests in the issuing entity that the sponsor would have been required to retain if the sponsor held the eligible vertical interest as a separate proportional interest in each class of ABS interest in the issuing entity;
- The fair value (expressed as a percentage of the fair value of all ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS interests are issued, as applicable)) of any single vertical security or separate proportional interests that would be (or was retained) by the sponsor at closing, and the fair value (expressed as a percentage of the fair value of all ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS interests are issued, as applicable)) of the single vertical security or separate proportional interests required to be retained by the sponsor in connection with the securitization transaction;
- A description of the methodology used to calculate the fair value of all classes of ABS interests; and
- The key inputs and assumptions used in measuring the total fair value of all classes of ABS interests (including the range of information considered in arriving at such key inputs and assumptions and an indication of the weight ascribed thereto) and the sponsor's technique(s) to derive the key inputs.

Several commenters asserted that the final rule should not require sponsors to measure and disclose the fair value of eligible vertical interests, so long as the underlying ABS interests have either a principal or notional balance. The commenters stated that a 5 percent interest in the cash flow of each class would always be equivalent to 5 percent of each class. In this regard, the commenters stated that requiring fair value measurement and disclosures for the vertical option would be unnecessary for ensuring compliance with the rule.

The agencies agree that calculation of fair value for eligible vertical interests is unnecessary. The agencies note that only those sponsors that rely exclusively on an eligible vertical interest to meet their risk retention requirements would not have to calculate the fair value of the ABS interests and make the related disclosures. A sponsor that wishes to receive credit for any residual interest that meets the requirements of an eligible horizontal residual interest (other than any portion of the residual retained as part of an eligible vertical interest) would be required to calculate the fair value of the ABS interests and make the related disclosures.

c. Restriction on Projected Cash Flows to Eligible Horizontal Residual Interest

The reproposal would have placed limits on projected payments to holders of the eligible horizontal residual interest. Specifically, the reproposal included a restriction on projected cash flows to be paid to the eligible horizontal residual interest that would have limited how quickly the sponsor would have been able to recover the fair value amount of the eligible horizontal residual interest in the form of cash payments from the securitization (or, if an eligible horizontal cash reserve account were established, released to the sponsor or other holder of such account). The sponsor would have been

[64] *See* 15 U.S.C. 77z–2.

[65] *See, e.g., Polin* v. *Conductron Corp.,* 552 F.2d 797, 806 n.28 (8th Cir. 1977); *Luce* v. *Edelstein,* 802 F.2d 49, 56 (2d Cir. 1986); *In re Donald J. Trump Casino Sec. Litig.,* 7 F.3d 357, 364 (3d Cir. 1993); *P. Stolz Family P'ship L.P.* v. *Daum,* 355 F.3d 92, 96–97 (2d Cir. 2004); and *Iowa Pub. Emps.' Ret. Sys.* v. *MF Global Ltd.,* 620 F.3d 137, 141–142 (2d Cir. 2010).

[66] *See, e.g.,* Rule 408 under the Securities Act; Sections 11, 12(a)(2) and 17(a) of the Securities Act; Section 10(b) of the Exchange Act; Rule 10b–5 under the Exchange Act; and Rule 12b–20 under the Exchange Act.

[67] *See supra* note 52.

prohibited from structuring a deal where it was projected to receive such amounts at a faster rate than the rate at which principal was projected to be paid to investors on all ABS interests in the securitization. The restriction was designed with an intention of enabling sponsors to satisfy their risk retention requirements with the retention of an eligible horizontal residual interest in a variety of ABS structures, including those structures that do not distinguish between principal and interest payments and between principal losses and other losses. The restriction was discussed in detail in the reproposal.[68]

The agencies invited comment in the reproposal on whether an alternative provision should be adopted relating to the amount of principal payments that could be received by the eligible horizontal residual interest. Under this alternative, on any payment date, in accordance with the transaction's governing documents, the cumulative amount paid to an eligible horizontal residual interest would not be permitted to exceed a proportionate share of the cumulative amount paid to all holders of ABS interests in the transaction. The proportionate share would equal the percentage, as measured on the date of issuance, of the fair value of all of the ABS interests issued in the transaction that is represented by the fair value of the eligible horizontal residual interest.[69]

The agencies received a significant number of comments regarding the proposed cash flow restrictions as well as the alternative approach on which they invited comment. Several commenters requested that the proposed cash flow restriction to the eligible horizontal residual interest and related certification be eliminated, either entirely or for specific asset classes, while one commenter proposed that the restriction be eliminated at sunset.

Several commenters suggested that the proposed restriction on cash flow distributions would be incompatible with a variety of securitization structures, such as those organized to have increasing overcollateralization over time, large amounts of excess spread at closing, or bullet maturities. Commenters stated that the reproposal's failure to distinguish between payments of interest and principal on the eligible horizontal residual interest would be particularly problematic for many transactions. Such structures highlighted by commenters included CMBS, where monthly cash flow comes predominantly from interest payments for much of the life of the securitization, with the result that these existing structures would not meet the test and would not have an economically attractive eligible horizontal residual interest (or B-piece) if they did meet the test. Several commenters also stated that the proposed cash flow restriction would be problematic for CLOs and other structures that use principal proceeds to reinvest in additional assets, but continue to pay interest, for significant reinvestment periods. One such commenter suggested that the final rule should specify that the use of proceeds to acquire new assets and reinvest does not constitute a payment with respect to the eligible horizontal residual interest.

Commenters raised a number of specific concerns regarding the calculations and projections that would be required by the proposed cash flow restriction. One commenter stated that the calculations that sponsors would be required to compare in order to determine whether restrictions are required would be too different to make effective comparison possible. Several commenters asserted that the calculations, disclosures, and certifications required by the proposed cash flow restriction were incompatible with revolving structures, since the asset pools of revolving structures change over time and the time at which the amortization period will commence is not always known at the closing date. These commenters suggested an alternative certification and calculation method for revolving structures. Another commenter suggested that when the ABS interest is a variable funding note that may have periodic increases and decreases in principal amount, the date of any increase or decrease should be treated as a new issue date for purposes of calculating the proposed cash flow restriction.

A few commenters asserted that the proposed cash flow restriction would significantly change the nature of the residual structure, since, for many structures, it would eliminate or severely restrict the payment of interest or yield to holders of the eligible horizontal residual interest. One commenter stated that if the holder of an eligible horizontal residual interest is not able to receive a return commensurate with the risk of the interest, the fair value of the interest will decrease, requiring that it represent a significantly greater portion of the capital structure of the securitization in order to reach 5 percent of the fair value of all ABS interests issued. Another commenter asserted that the proposed cash flow restriction would discourage sponsors from structuring offerings of ABS interests with excess spread exceeding 5 percent of the fair value of the transaction because the restriction would effectively prevent sponsors from reducing such excess spread to 5 percent during the life of the transaction.

The certifications and disclosures to investors that would have been required by the proposed cash flow restriction were also a focus of concern for commenters. Several commenters expressed concern about potential liability that could result from the proposed requirement that sponsors certify to investors that they had performed the required calculations and to certify their expectations regarding the cash flow to the eligible horizontal residual interest as compared to more senior ABS interests. Commenters stated that sponsors could be subject to liability, if their projections and assumptions differed from actual results. One commenter specifically contended that the difficulty in accurately modeling prepayment risks heightens the risk of liability. Two commenters suggested that a safe harbor should be granted to protect sponsors from such liability risk. One such commenter requested limiting the safe harbor to sponsors who utilize reasonable methodologies in making the required calculations. A different commenter suggested that, rather than requiring the sponsor to make the certifications to investors, the sponsor should only have to maintain a record of the closing date calculations, including the methodology and material assumptions underlying them, and make those records available to the Commission and banking agencies upon request for five years. One commenter suggested that the proposed certification to investors should be replaced with a requirement that the sponsor disclose to investors, in the offering documents, that it has performed and met the cash flow restriction test.

The agencies also received comments regarding the proposed requirement that sponsors would have to disclose their past performance in respect to the cash flow calculations. One commenter raised concern that requiring such disclosures could create potential liability issues concerning false disclosures. Two commenters suggested a modification to the proposed requirement such that the sponsor would have to disclose the number of payment dates on which the actual payments made to the sponsor under the eligible horizontal residual interest exceeded the amounts projected to be paid to the sponsor on such payment

[68] Revised Proposal, 78 FR at 57938.

[69] *See* Revised Proposal, 78 FR at 57941.

dates. These commenters asserted that the focus of this disclosure should be on the cumulative amount of payments made to the holder of the eligible horizontal residual interests, rather than the cash flow projected to be paid to the sponsor on the payment dates.

Several commenters offered qualified support for the alternative proposal on which the agencies invited comment. Such support was largely based on the fact that the alternative proposal would have required the comparison of all forms of payment to both the eligible horizontal residual interest and the investor interests, while the proposed cash flow restriction would have required the comparison of all forms of payment to the eligible horizontal residual interest and only principal payments to the investor interests. Two commenters asserted that, without a detailed proposal, it is difficult to determine what type of cash flow comparisons the agencies intended to cover with the alternative proposal and that they would not support any proposal that does not allow for market rates of return to be paid to the eligible horizontal residual interest. One commenter would support the alternative proposal if it were modified to clarify that a residual interest, in order to be considered an eligible horizontal residual interest, be limited in the amount of principal repayments it may receive, such that the cumulative amount of payments applied to reduce its principal or notional balance as of any payment date is proportionate to (or less than) the cumulative amount of payments applied to reduce the principal or notional balance of all ABS interests in the transaction as of such payment date. One commenter requested a modified version of the alternative proposal that the commenter said would be more appropriate for CMBS transactions. The commenter asserted that, since CMBS bonds associated with the horizontal risk retention interest are sold at a discount, the alternative proposal should allow the percentage of cash flow paid to the horizontal risk retention holder to be based on the face value, rather than the fair value, of their purchased interest.

Commenters also offered various alternative proposals to the proposed cash flow restriction. One commenter requested that a sponsor be considered to have met its risk retention obligation if it satisfies one of the following tests on the closing date based on projections or assumptions of timely payment: (1) The projected fair value of the amount retained as of each payment date will not be less than the required 5 percent; (2) the level of overcollateralization calculated based on the amortizing balance of the ABS interests as of each payment date, is not projected to decline below 5 percent over the life of the transaction; or (3) the projected principal payments to be paid to the eligible horizontal residual interest, as of each payment date, will not exceed its pro rata share of all payments made to ABS interest holders on such payment date. One commenter suggested that the test should be limited to a projection that the retained risk will be equal to at least 5 percent of the sum of the projected aggregate fair value of all ABS interests in the issuing entity, other than the eligible horizontal residual interest, and the projected fair value of the eligible horizontal residual interest.

After careful consideration of the comments, the agencies agree that the restrictions on projected cash flow to the eligible horizontal residual interest included in the proposed rule would not operate without significant risk of unintended consequences. Furthermore, the agencies have not identified a cash flow restriction mechanism that would function effectively across asset classes without having an unduly restrictive impact on particular asset classes. While the agencies could consider different tests for different classes, the agencies believe that would lead to a more complicated rule that could be difficult to administer and that would likely engender more opportunity to undermine the impact of the final rule on the alignment of interests between the sponsor and investors. Additionally, the agencies believe that alternatives suggested by commenters that proposed to restrict cash flows based on a comparison of projections of the face value of securitized assets and the face value of outstanding ABS interests (which do not capture expected credit losses, among other things) and alternatives that focused only on repayment of principal either would be easily evaded or would not effectively further the statutory goals and directive of section 15G of the Exchange Act to limit credit risk and promote sound underwriting. Accordingly, the agencies are not including in the final rule the proposed cash flow restriction, the alternative described in the reproposal, or the alternatives suggested by commenters.

The agencies are concerned that risk retention may become less meaningful when a sponsor quickly recovers the value of risk retention through distributions. However, the agencies note that the final rule requires disclosure regarding the material terms of the risk retention interest, and the timing of cash flows and determination of fair value, which is designed to facilitate investor determination of whether the risk retention interest to be held by the sponsor remains meaningful over time. In addition, while the rule requires that the sponsor measure an eligible horizontal residual interest only as of the closing of a transaction (and, under certain circumstances, if additional ABS interests are issued thereafter), the rule also restricts the ability of a sponsor to transfer or hedge any interest in the credit risk of the securitized assets it is required to retain until the expiration of specified periods. Therefore, the rule is designed so that the sponsor remains exposed to the credit risk of securitized assets, up to the amount required to be retained. If the agencies observe that either the assumptions and methodologies used to calculate the fair value of horizontal risk retention or the structuring of securitization transactions—including structuring of payments to the residual interest—tends to undermine the ability of the risk retention to align the interests of sponsor and investors, the agencies will consider whether modifications to the rule should be made to address these issues.

2. Master Trusts: Revolving Pool Securitizations

a. Overview of the Reproposal and Public Comments

Many securitization sponsors face a mismatch between the maturities of the assets they seek to securitize and the maturities of bonds sought by investors in the market. In order to obtain best execution for a securitization of those assets—or in other cases, in order to obtain any investor interest in the market of any kind—the sponsor must use a structure that transforms the available cash flow from the assets into debt with a maturity and repayment type (amortizing or bullet) sought by investors. Furthermore, if the sponsor's business generates an ongoing stream of assets to be securitized under these circumstances, especially (but not always) if the assets are receivables generated from revolving credit lines, the sponsor faces unique challenges in structuring its securitization.

One solution to these issues, which has evolved over the last 25 years, is a type of revolving pool securitization commonly known as a ''master trust'' securitization. Master trusts generally issue multiple series of asset-backed securities over time, collateralized by a common pool of securitized assets. The transaction documentation requires the sponsor to maintain the collateral

balance at an amount that is at all times sufficient to back the aggregate amount of outstanding investor ABS interests with a specified amount of collateral above that amount. The amount of outstanding investor ABS interests changes over time as new series are issued or existing series are paid down. Moreover, as each series is issued, it begins with a revolving period (typically for some number of years), during which the holders of investor ABS interests receive only interest, and cash from borrower principal repayments on the securitized assets are used to buy additional assets for the pool from the sponsor. This provides the sponsor with ongoing funding for its operations, and maintains the level of securitized assets over time. Then, at a date specified under the terms of the series, the revolving phase for the series comes to an end, and cash from borrower principal repayments on securitized assets is used to repay investors and retire that series of investor ABS interests.

Separately from the issue of credit enhancement for the investor ABS interests, which is discussed below, investors are concerned that the total amount and quality of securitized assets does not decline unacceptably during the revolving period of the series. If that were to happen, the master trust could face difficulties repaying investors months or years later when the series matures. To protect against this, the sponsor is typically required, at various intervals, to measure the amount by which the aggregate principal balance of the securitized assets exceeds the aggregate principal balance of the outstanding investor ABS interests. If this ''cushion'' of securitized assets falls below a target level, the sponsor has a specified cure period in which it may add more assets to restore the pool to its required target size.[70] Credit quality problems with the securitized assets would lead to elevated charge-offs of securitized assets, which in turn could cause the pool to fall below the target level.[71]

If the sponsor cannot restore the pool balance to its required target level within the cure period, the master trust commences an ''early amortization mode.'' Once that occurs, the sponsor may no longer use borrower payments on the securitized assets to purchase additional loans to transfer to the securitization, and interest and principal payments on the securitized assets are used to begin paying down outstanding investor ABS interests as rapidly as practicable. The consequences to the sponsor are significant, since early amortization of the master trust means the sponsor will no longer have access to securitized funding through the master trust for future securitized assets generated in connection with the sponsor's operations.

The agencies' reproposal would have recognized the ''seller's interest'' retained by a master trust sponsor as an acceptable form of risk retention to meet the sponsor's obligations under the rule. In many master trusts, the ''seller's interest'' is the amount by which the outstanding principal balance (or equivalent measurement) of the assets held by the master trust exceeds the outstanding principal balance of the outstanding ABS interests and is required by the series transaction documents to be maintained at or above a specified percentage of the aggregate outstanding investor ABS interests, measured monthly (*e.g.,* the seller's interest in the principal balance of pool collateral is required to equal at least 5 percent of the principal balance of all outstanding investor ABS interests). The seller's interest is not attached to specific pool collateral; it is an undivided interest in the entire pool akin to a participation interest, representing the sponsor's entitlement to a percentage of the total principal and interest or finance charge payments received on the pooled securitized assets for every payment period (typically monthly). Investors in the various series of ABS interests issued by the master trust have claims on the remaining principal and interest or finance charge payments, as the source of repayment for the ABS interests they purchased from the master trust. The seller's interest in these structures is generally *pari passu* with the investor ABS interests, resulting in the sponsor incurring a *pro rata* share of credit losses on securitized assets, in a percentage amount equal to the percentage amount of the seller's interest as calculated under the terms of the transaction documents.[72]

The agencies' reproposal would have treated a *pari passu* seller's interest as a separate form of risk retention. The reproposal would have allowed this option to be used only by issuing entities organized as master trusts, established to issue on multiple issuance dates one or more series of ABS interests, all of which are collateralized by a common pool of assets that will change in composition over time. The reproposal would have required distributions to the sponsor on the seller's interest to be *pari passu* with each series of investor ABS interests, prior to an early amortization event as defined in the transaction documents. The sponsor would have been required to meet the 5 percent threshold for its seller's interest at the closing of each issuance of ABS interests by the master trust, and at each seller's interest measurement date specified in the transaction documents, but no less often than monthly. The reproposal would have required the seller's interest to be retained by the sponsor or by a wholly-owned affiliate of the sponsor.

For so-called ''legacy master trusts''—which hold revolving pools of collateral and issue a certificate that entitles the holder to distributions on that collateral to another one of the sponsor's master trusts, which in turn securitizes those distributions into investor ABS interests—the reproposal would have allowed the seller's interest with respect to the legacy trust assets to be held by the sponsor at the level of either trust, in proportion to their differing asset pools. The agencies also proposed to allow an offset against the required seller's interest, on a dollar-for-dollar basis, for so-called ''excess funding accounts.'' These accounts receive distributions that would otherwise be paid to the holder of the seller's interest if the sponsor fails to meet the minimum seller's interest requirement. In the event of an early amortization of the master trust, funds from the excess funding account would be used to make distributions to outstanding investor ABS interests, in the same manner as distributions on pool collateral during early amortization.

In the reproposal, the agencies also observed that some of the master trusts in the market are not structured to include a *pari passu* seller's interest of a sufficient size to meet the proposed rule's 5 percent trust-wide requirement. In an effort to accommodate sponsors of these trusts, the reproposal would have allowed the sponsor to reduce its 5 percent *pari passu* seller's interest requirement by whatever corresponding percentage of horizontal ABS interest the sponsor held in the structure. The reproposal would have given the sponsor credit for an eligible horizontal residual interest under section 4 for these purposes, as well as an alternative form of horizontal risk retention based

[70] Instead of adding assets, the sponsor might also avail itself of options described in the transaction documents to reduce or repay outstanding investor ABS interests.

[71] The level of securitized assets in the pool might also fall if securitized assets are repaid according to their terms and the master trust does not use the repaid principal to acquire replacement securitized assets from the sponsor.

[72] A 5 percent *pari passu* seller's interest is commonly required in credit card master trusts.

on excess spread (described below). The sponsor would have been required to determine the percentages of horizontal retention on a fair value basis, consistent with the reproposal's treatment of other subordinated forms of risk retention. Furthermore, any gap between the amount of trust-wide *pari passu* seller's interest held by the sponsor and the 5 percent minimum requirement would have been required to be offset with an equivalent fair value percentage of the permitted horizontal interests for every outstanding series issued by the master trust.

Another alternative form of horizontal risk retention that would have been recognized by the reproposal was designed to allow sponsors to receive risk retention credit for excess spread, which constitutes a significant portion of the credit enhancement in master trusts collateralized by credit card receivables. These master trusts are structured with two separate cash waterfalls, one for principal repayments collected from borrowers and one for interest and fees (finance charges) collected from borrowers. Interest and fees collected from borrowers each payment period are used to cover the master trust's expenses and to pay interest due on outstanding investor ABS interests for the period, and the remaining interest and fee collections are then made available to cover principal charge-offs on securitized assets. The sponsor is then entitled to collect whatever interest and fee collections remain. Absent application of the excess interest and fee collections to cover principal charge-offs, the principal charge-offs would result in the balance of outstanding investor ABS interests being reduced. Accordingly, the reproposal would have recognized the sponsor's interest in the residual interest and fees (excess spread) as a subordinated form of horizontal risk retention, if it was structured in the manner described in this paragraph, so long as the master trust continued to revolve, and the sponsor determined and disclosed the fair value of the residual interest and fees on the same monthly basis as its *pari passu* seller's interest.

The reproposal also included provisions clarifying that a master trust entering early amortization and winding down would not, as a result, violate the rule's requirement that the seller's interest be *pari passu.* During early amortization, distributions on this form of seller's interest typically become subordinated to investor interests, to allow for the repayment of the outstanding investor ABS interests more rapidly.

The agencies received extensive comments on the overall design and the details of the reproposal's option for master trusts. Commenters stated that the agencies needed to make numerous revisions to the mechanics of the reproposal for master trusts or the seller's interest option would not be useable by most revolving pool securitization structures in the market. Moreover, commenters stated that most revolving pool securitizations in the market would be left with no mechanism for horizontal risk retention under the rule whatsoever, because the requirements in section 4 of the reproposed rule for an eligible horizontal residual interest conflicted with key provisions of those revolving pool securitizations. Commenters pointed out that revolving pool securitization structures have evolved beyond credit cards and automobile dealer floorplan financing, to encompass numerous specialized asset classes important to the U.S. economy. Examples they cited included a wide variety of floorplan and trade receivable financing for commercial manufacturing firms, other non-revolving short-term assets such as insurance premium loans and servicer advance receivables, a broad variety of equipment leasing programs, and home equity line receivables. Commenters identified two overarching concerns with the reproposal, and also made numerous, more detailed recommendations for revisions to the mechanics of the rule.

The first area of overarching concern for commenters centered on the agencies' proposed treatment of subordinated forms of risk retention in the master trust context. In the reproposal, the agencies noted the existence of subordinated forms of seller's interests in the market. The agencies invited comment on whether subordinated seller's interests should be given risk retention credit under the rule, but also pointed out that the agencies were inclined to require it to be measured on a fair value basis, consistent with the treatment of other forms of subordinated risk retention under the reproposal. Commenters said many revolving pool securitizations in the market relied on subordinated seller's interests as the principal source of credit enhancement and, therefore, it was critical for the agencies to include it in the rule.[73] Commenters also said that monthly calculations of fair value, as suggested by the agencies in the reproposal, would be immensely burdensome. Commenters said this burden was especially unwarranted in the case of revolving pool securitizations, which do not monetize excess spread and, therefore, do not present the risks of evasion through deal structures that motivated the agencies' restrictions on other forms of horizontal risk retention. Commenters also said that the agencies' concerns about sponsor manipulation and evasion were misplaced, because revolving pool securitization sponsors rely on the funding they thereby obtain as a principal source of ongoing funding for their business operations. Commenters said this creates an alignment of interests between sponsors and investors that is the opposite of the originate-to-distribute model.[74]

The other areas of concern for commenters were differences between the reproposal's requirements for the eligible horizontal residual interest and the terms of existing revolving pool securitizations in the market. First, commenters said the cash flow recovery percentage calculations were structurally incompatible with revolving pool securitizations.[75] Second, commenters expressed heightened concerns about their potential liability for disclosing predictions and assumptions about the future performance of a revolving pool securitization, in connection with making the fair value determination

[73] One group of commenters said the typical *pari passu* seller's interest in a floorplan securitization was zero percent, and they were aware of no floorplan securitization with one higher than 2 percent. These commenters said that a subordinated seller's interest was, like a *pari passu* seller's interest, typically calculated as a set percentage of additional assets required to be held in the collateral pool, over and above an amount equal to the total amount of outstanding investor ABS interests (though this percentage is often determined on a series-by-series basis rather than a trust-wide basis). Principal and interest payments made with respect to this subordinated seller's interest are distributed to the sponsor, *after* they are first applied to cover any charge-offs of securitized assets that would otherwise reduce the principal amount of outstanding investor ABS interests. The sponsor's share of principal and interest distributions is also available to cover shortfalls in payments of principal and interest due to investors.

[74] Commenters representing automobile, equipment, and dealer floorplan manufacturers were among those advocating for a simplified risk retention alternative, without fair value requirements and cash flow restrictions, for ''simple'' securitization structures that issue only ''traditional'' interest bearing asset-backed securities with 5 to 10 percent overcollateralization on a face value basis and weighted average interest rates on the issued asset-backed securities in line with that of the securitized assets. The agencies note that the elimination of the cash flow restrictions from section 4 of the rule, accompanied by the treatment of subordinated seller's interests adopted in the final rule, should significantly address the source of commenters' concerns in this regard.

[75] The agencies note that the elimination of the cash flow restrictions from section 4 of the rule addresses commenters' concerns in this regard.

required by the rule. Third, commenters asserted that the requirement for the eligible horizontal residual interest to be the most subordinated claim to payments of both principal and interest could not be achieved when the sponsor is also entitled to collect residual interest and fees, because there are separate interest and principal waterfalls and the subordinated junior bond in the series held by the sponsor (whether or not it is certificated or rated) is usually structured to be paid interest before the allocation of interest and fee collections to cover charge-offs otherwise allocable to senior bonds (and in some cases, charge-offs allocable to the junior interests held by the sponsor as well).

Commenters said that sponsors sought the ability to continue incorporating subordinated seller's interest or residual ABS interest in excess interest and fees into their deal structures and simultaneously retain a junior bond, while still having the flexibility to choose which combination of those interests the sponsor would use to comply with the risk retention requirements. Commenters placed particular importance on retaining the flexibility to do this without being required to engage in fair value determinations for the interests the sponsor does not count for purposes of regulatory compliance.

In addition, commenters expressed concerns about paragraphs (2) and (3) of the eligible horizontal residual interest definition in connection with the series-level allocations and delinked structures used in revolving pool securitizations.

Commenters also asked the agencies to modify the rule's subordination requirements to allow a subordinated tranche held as an eligible horizontal residual interest to be repaid prior to later-maturing senior tranches, noting that, in delinked structures, a subordinated tranche which enhances one or more senior tranches may mature before the senior tranche. In these circumstances, commenters said the securitization transaction documents contain terms requiring the subordinated tranche to be replaced to the extent the remaining senior tranches still require credit enhancement under the terms of the transaction documents.

In addition to these concerns, commenters requested numerous changes they said were necessary to recognize the risk retention existing in revolving pool securitizations in the current market.

Commenters said many revolving securitization structures that are commonly referred to as ''master trusts'' do not, in fact, use issuing entities organized in the form of a trust, and their organizational documents do not necessarily state that they are established to issue multiple series. Commenters also expressed concern about whether sponsors universally hold their seller's interests in the form of an ''ABS interest'' as defined in the reproposed rule.

Commenters requested clarification as to whether the requirement that the master trust be collateralized by a common pool of securitized assets means that every series must be secured by every asset held by the issuing entity. Commenters explained that some revolving pool securitizations may use collateral groupings, and further that principal accumulation and interest reserve accounts may be held only for the benefit of an identified series. Commenters also requested clarification as to whether the common pool requirement prevents the issuing entity from holding assets that are not eligible to support issuance of additional ABS interests to investors (such as excess concentration receivables), but are nonetheless pledged as collateral to the structure, with proceeds from these ineligible assets being allocated to the sponsor, sometimes with varying extents of subordination to one or more series of outstanding investor ABS interests.

In the reproposal, the agencies invited comment on whether, if a sponsor is relying on the seller's interest as its required credit risk retention under the rule, the final rule should preclude the master trust from monetizing excess spread, in exchange for allowing the seller's interest to be calculated on the basis of the principal balance of outstanding investor ABS interests instead of the fair value of outstanding investor ABS interests. Commenters questioned the agencies' rationale for this restriction, asserting that revolving pool securitizations that generate excess spread do not monetize it through the issuance of interest-only securities or premium bonds. Commenters said revolving pool securitizations do exactly the opposite, making excess spread available to cover losses that would otherwise reduce the principal repayments to outstanding investor ABS interests.[76]

Commenters questioned why the reproposal would, as a general rule, permit a majority-owned affiliate of a securitizer to hold the securitizer's risk retention interest required by the rule, but in the case of revolving pool securitizations would only permit the seller's interest or special horizontal interest to be held by the securitizer or a wholly-owned affiliate of the securitizer.

Commenters also requested that the agencies revise the rule to permit risk retention in legacy master trusts to be held at the legacy master trust level, not only for seller's interests, as the agencies proposed, but also for horizontal forms of risk retention permitted under the rule.

Commenters requested that the agencies make changes to the details of the definition of seller's interest concerning the requirement that the sponsor's distributions on the seller's interest be *pari passu* prior to an early amortization event. Commenters pointed out that principal distributions on the seller's interest are subordinated to a series of outstanding investor ABS interests in a controlled accumulation phase or amortization, because the transaction documents typically fix the proportions for allocation of principal distributions to the series at the start of the accumulation phase or amortization period.[77]

With respect to the reproposal's requirement for master trusts to measure the seller's interest on the measurement date specified in the transaction documents, no less than monthly, commenters requested two changes. First, commenters stated that some revolving pool securitizations require measurements of the seller's interest on a more frequent basis, and that they should not be required to measure the seller's interest for regulatory compliance purposes more often than monthly (and at the closing of each issuance of ABS interests).[78] Second, commenters requested the agencies to recognize the cure period afforded them under their transaction documents. Commenters also requested changes to the specifics of the disclosure requirements with respect to the cut-off dates for disclosing the amount of seller's interest retained by the sponsor.

Commenters also requested changes to the details of the reproposed rule's

[76] Commenters also expressed concern as to how the agencies could define the difference between premium bonds and bonds that price above par due to investor enthusiasm for a particular bond.

[77] Moreover, some revolving pool securitizations allocate principal during an accumulation phase pursuant to a formula that captures all available principal collections from the assets that are not otherwise needed for other principal accumulation accounts and acquisition of new pool collateral.

[78] Commenters said that the measurement referred to by the agencies in the reproposal, for purposes of determining whether the sponsor must add more assets to the collateral pool, generally takes place monthly. However, the seller's interest is measured more frequently (as often as daily) for other purposes, such as verifying whether cash may be released to the sponsor.

treatment of excess funding accounts and the provisions on early amortization, to better reflect the way early amortization triggers are currently structured.

Commenters supported the reproposal's inclusion of residual interest and fees as a recognized form of risk retention for revolving pool securitizations. They recognized the rationale for requiring sponsors using the option to measure it on a fair value basis, but expressed concern that the burdens of performing the valuation monthly would be so substantial as to dissuade all but a few revolving pool securitizations from using the option. Commenters also requested some changes and clarifications to the mechanics of the rule language in the reproposal, to accommodate established structures being used in the market. They also requested that the agencies eliminate the requirement for separate interest and principal waterfalls.

Commenters supported the reproposal's inclusion of provisions allowing revolving pool securitizations to offset and reduce their 5 percent seller's interest with corresponding amounts of horizontal interests. They objected to the agencies' requirement that the offsetting amount be held with respect to every series in the trust, and requested that the agencies permit the offset to be determined on a weighted average basis across all series of outstanding investor ABS interests. Commenters also requested that, if a sponsor held the horizontal interest jointly with an investor, the sponsor be allowed to take credit for its proportional holding in that horizontal interest.

Commenters agreed with the agencies that it is not practicable to create a grandfathered status for seller's interest, since it represents the sponsor's undivided interest in, and exposure to, the common pool of securitized assets in the trust, on a trust-wide basis. Commenters suggested that a revolving pool securitization relying on horizontal interests to offset any portion of the seller's interest should be allowed to do so on a grandfathered basis, whereby the sponsor would only be required to hold that horizontal element with respect to series issued after the applicable effective date of the rule.

Commenters also described a type of revolving pool securitization that securitizes mortgage servicer advance receivables, in which the seller's interest is fully subordinated to all expenses and investor obligations. These commenters requested inclusion of these subordinated interests as part of the master trust option, and inclusion of certain series-specific interest reserve accounts as an offset to the minimum seller's interest.

b. Description of the Final Rule

The agencies are revising the master trust option in the final rule in order to make the option available to more commercial firms that currently rely on revolving pool securitizations as an important component of their funding base. These revisions recognize and accommodate the meaningful exposure to credit risk currently held by sponsors of these vehicles, in light of the heightened alignment of incentives between sponsors and investors that attaches to their revolving nature. The agencies are also making a number of other refinements in the final rule in order to align it more closely with the mechanics of revolving pool securitizations as they are structured in the market today.

The *pari passu* seller's interest option proposed by the agencies represents a special form of over-collateralization for the ABS interests issued by a revolving pool securitization. Under the final rule, sponsors must maintain the size of the seller's interest position, which they most commonly do through the ongoing addition of assets to the pool or repayment of investor ABS interests, if the existing pool is diminished by charge-offs exceeding expected loss rates.

The agencies are also adopting an additional change requested by commenters to accommodate other revolving pool securitizations that are common in the market and rely on over-collateralization in a different manner, which varies between asset classes. Commenters described two different structures, one of which the agencies are persuaded should be recognized as an eligible form of risk retention under the final rule. This form was described by commenters as a common feature of some asset classes, such as equipment leasing and floorplan financing. In these revolving pool securitizations, the sponsor is obligated, as is the case in the *pari passu* seller's interest structure, to maintain an undivided interest in the securitized assets in the collateral pool, in an amount equal to a specified percentage of the trust's outstanding investor ABS interests. Whereas the *pari passu* seller's interest is a trust-level interest equal to a minimum percentage of the revolving pool securitization's combined outstanding investor ABS interests, the minimum percentage in these structures may be tied to the outstanding investor ABS interests in each separate series. While the sponsor's right to receive distributions on the seller's interest included in the reproposal was required to be *pari passu,* the sponsor's right to receive its share of distributions on its subordinated seller's interest may be subordinated to varying extents to the series' share of credit losses.

Importantly, notwithstanding these differences with the *pari passu* seller's interest, the sponsor of this form of revolving pool securitization is still required under the transaction documents to maintain the specified minimum percentage amount of securitized assets in the pool if the securitization is to continue revolving, through the ongoing addition of extra securitized assets to the pool if necessary. The agencies believe this requirement to maintain the specified minimum percentage amount creates incentives for the sponsor to monitor the quality of the securitized assets added to the pool in both structures. If the sponsor replaces depleted pool collateral with poorly underwritten assets, those assets will, in turn, underperform, and the sponsor will be obligated to add even more assets. If this cycle is perpetuated and the specified minimum percentage amount is breached, the deal will enter early amortization, and the sponsor's access to future funding from the structure will be terminated. In consideration of this, the agencies have made modifications so that the final rule recognizes this subordinated form of seller's interest as an eligible form of risk retention for revolving pool securitizations, because the agencies believe this form aligns the interests of sponsors and investors in a manner similar to other forms of risk retention recognized pursuant to the final rule.

The second form of revolving pool securitization described by commenters as used in some asset classes, such as equipment leasing and floorplan financing, represents various types of excess securitized assets. The transaction documents for revolving pool securitizations typically impose eligibility requirements on the securitized assets that are allowed to be included as collateral for purposes of calculating the total amount of outstanding investor ABS interests that may be issued by the revolving trust. According to commenters, these eligibility requirements include concentration limits on securitized assets with common characteristics, such as those originating from a particular manufacturer or dealer or a particular geographic area. The sponsor places assets in the revolving pool securitization that do not meet these requirements (excess concentration

receivables), but these ineligible assets are not included when calculating the total amount of outstanding investor ABS interests the revolving pool securitization may issue. Commenters asserted that these ineligible assets are often subject to the pledge of collateral to the ABS investors, but distributions on these assets are typically allocated to the sponsor. Depending on the terms of the securitization, the sponsor's claim to the cash flow from these excess assets may be partially or fully subordinated to investor interests, and these subordination features may be at the trust level, at the series level, or some combination of both.

The agencies are not persuaded that the sponsor's interest in these receivables should be included as eligible risk retention. By their terms, these are assets that are not representative of the assets that stand as the principal repayment source for investor ABS issued by the revolving pool securitization.

To accommodate revolving pool securitizations with subordinated seller's interest, the agencies have revised the distribution language in the definition of seller's interest to include seller's interests that are *pari passu* with each series of investor ABS interests, or partially or fully subordinated to one or more series in identical or varying amounts with respect to the allocation of all distributions and losses on the securitized assets. This language retains the vertical nature of the proposed seller's interest, since the sponsor must receive at least its *pro rata* share of losses on securitized assets through the *pari passu* aspect of the distribution. The sponsor is also free to use its *pari passu* share of distributions from securitized assets to provide loss protection to outstanding investor ABS interests, thereby subordinating its interest. The final rule provides that these levels of subordination may be varied, thereby affording the sponsor flexibility with regard to the extent of this subordination. For example, the sponsor may provide varying levels of subordination to different series, or provide different levels of subordination depending on the occurrence of triggers specified in the transaction documents.

Commenters stated that structures with *pari passu* seller's interest also often include elements of conditional subordination that are included to accommodate investor or rating agency concerns that vary from transaction to transaction. These are also permitted pursuant to the final rule. The agencies believe this flexibility is necessary to accommodate the kinds of variations in current market practice from deal to deal that commenters described in their comment letters. Nevertheless, the flexibility afforded under the rule does not permit the sponsor to participate in distributions to any extent greater than *pari passu.* Therefore, the seller's interest may not be senior to any series of investor ABS interests with respect to allocation of distributions pursuant to the seller's interest.

Commenters asserted that revolving pool securitizations typically provide different distribution regimes for seller's interests if the securitization moves into early amortization. The reproposed rule contained language reflecting this, relieving the seller's interest from the *pari passu* distribution requirement only after an ''early amortization event.'' In response to these comments, the agencies have removed the technical reference to a triggering event and substituted functional language describing a revolving pool securitization in early amortization, as specified in the securitization transaction documents.[79]

In addition, the agencies have modified slightly the operational portion of the final rule text allowing retention of a seller's interest to satisfy a sponsor's risk retention obligation. Whereas the reproposal obligated the sponsor to ''retain a seller's interest of not less than 5 percent,'' the final rule requires the sponsor to ''*maintain* a seller's interest of not less than 5 percent'' (emphasis added). The agencies believe that the sponsor's obligation to replenish the seller's interest underlies the alignment of interests unique to the revolving pool securitization structure. Commenters indicated that there are some forms of subordinated seller's interest that the sponsor is not required to replenish. These do not qualify for the seller's interest option under the final rule.

The definition of seller's interest in the final rule provides that ineligible assets—specifically, assets which are not eligible under the terms of the securitization transaction to be included when making periodic determinations whether the revolving pool securitization holds aggregate securitized assets in the required specified proportions to aggregate outstanding investor ABS interests issued by the revolving pool securitization (*e.g.,* excess concentration receivables)—are not to be considered a component of the seller's interest.[80] By the terms of the transaction documents, these are assets that are typically not representative of the assets that stand as the principal repayment source for investor ABS interests issued by the revolving pool securitization, and the agencies are declining to grant commenter's request that they be recognized as a form of risk retention comparable to the forms of seller's interest recognized under the rule. The agencies have also clarified the proposed exclusion from seller's interest of assets that have been allocated as collateral only for a specific series. As the agencies discussed in the reproposal, this exclusion was designed to accommodate limited forms of exclusion in connection with administering the trust, accumulating principal, and reserving interest.[81] To reflect this condition within the rule text itself, the agencies have revised the exclusion so it applies only to servicing assets.

To address certain comments about the application of the definition of eligible horizontal residual interest to revolving pool securitizations, the agencies have modified paragraph (2) of the definition of eligible horizontal residual interest to refer to allocation dates as well as payment dates.[82] The agencies also confirm that, in applying the eligible horizontal residual interest definition to a revolving securitization with multiple series, the requirements in paragraphs (2) and (3) specifying priority of payment with respect to amounts due to other interest holders and requiring subordination are to be applied with respect to the series supported by the particular eligible horizontal residual interest (including, where applicable, certain delinked structures), and should only be construed to refer to all outstanding investor ABS interests if the eligible horizontal residual interest is, in fact, structured to function as an enhancement to all outstanding investor ABS interests issued by that revolving pool securitization. To accommodate delinked structures, commenters requested that the agencies allow replacement of a subordinate tranche before maturity of the senior tranches it supports. The agencies are not adopting

[79] As discussed above, the definition of seller's interest has also been revised to allow, prior to early amortization, subordinated distributions.

[80] One group of commenters recommended that the agencies simply modify the seller's interest definition to exclude assets within the revolving pool securitization that secure less than all of the ABS interests. The agencies are implementing this approach in a more targeted way by identifying the particular categories of assets to be excluded.

[81] Revised Proposal, 78 FR at 57943, n.52.

[82] Commenters stated that the reproposal's definition of eligible horizontal residual interest refers to loss allocations occurring on ABS interest payment dates, whereas revolving pool securitizations allocate losses periodically, in advance of ABS interest payment dates.

this requested modification. The agencies note that, to serve as risk retention pursuant to the rule, the sponsor must retain an eligible horizontal retention interest for the life of the securitization it supports, and the agencies believe sponsors can readily structure their retained residual interests to achieve this outcome.[83]

The risk retention options described in section 5 of the final rule are available only to a specific category of securitization vehicles, originally defined as ''revolving master trusts'' but now defined as ''revolving pool securitizations.''[84] The option is not available to an issuing entity that issues series of ABS interests at different times collateralized by segregated independent pools of securitized assets within the issuing entity such as a series trust, or an issuing entity that issues shorter-term ABS interests collateralized by a static pool of securitized assets, or an issuing entity with a predetermined re-investment period that precedes an ultimate amortization period.

Commenters expressed concern that language in the revolving pool securitization definition requiring the issuing entity to be ''established to issue on multiple issuance dates one or more series'' would require them to re-constitute their issuing entities. The agencies note that the rule does not require specific statements of intention to issue multiple series in the issuing entity's organizational documents. That being said, the agencies believe that the ability to issue more than one series of ABS interests is one of the defining characteristics of the structure.[85] In light of this, the agencies are replacing the ''one or more'' language with rule text requiring the issuing entity to be established to issue ''more than one'' series. While the rule requires no specialized documentation of this intention to be made in connection with the issuing entity's legal organization, the sponsor must be able to establish that, under the constituent legal powers of the entity pursuant to applicable law, the issuing entity has the authority to issue more than one series. The agencies also recognize that a business organization might establish a revolving pool securitization vehicle and, after issuing one series, changes in circumstances could prevent the sponsor from seeking to issue any additional series, with the structure ceasing to revolve and amortizing out. The agencies typically would not dispute this issuing entity's eligibility under section 5 of the rule in hindsight, absent facts and circumstances indicating the sponsor sought to use the structure to improperly avoid the standard risk retention obligations of section 4 of the rule. A business organization that did so more than once would face a heightened burden to establish that its reliance on section 5 of the rule was not a violation of its obligations under the rule.

The final rule retains the reproposal's requirement that the issuing entity's ABS interests are collateralized by a common pool of securitized assets that will change in composition over time. This is another defining characteristic of a revolving pool securitization eligible to use section 5 of the rule. Under these structures, principal collections on the securitized assets (net of funds required to amortize the principal of outstanding investor ABS interests or to accumulate such funds) are used to purchase additional assets to collateralize existing and future investor ABS interests in the securitization on a revolving basis, with no predetermined end date.[86] Revolving pool securitizations allow sponsors to restructure the cash flows on the securitized assets not only for credit enhancement, but for mismatches between the maturities of the securitized assets and the maturities of ABS interests that are sought by the market on attractive terms.[87]

Commenters requested further clarification about the common pool requirement. One concern centered on the presence of ineligible assets, including so-called ''excess concentration'' receivables. The agencies observe that, on the one hand, these ineligible assets are part of the asset pool, and proceeds from them may even be used to cover losses that would otherwise be allocated to investors. On the other hand, the bulk, or in many cases all, of the proceeds from the ineligible assets are directed to the sponsor, and the receivables are not eligible to be included when determining the revolving pool's limit on outstanding investor ABS interests. The agencies do not consider these arrangements to violate the common pool requirement, though as noted above the final rule does not permit these assets to be included when calculating the size of the seller's interest.

Notwithstanding the agencies' willingness to accommodate these ineligible assets that are allocated to the sponsor, if a revolving pool securitization designated a collateral group as the securitized assets for a specific series, the arrangement would not meet the common pool requirement. In this vein, commenters requested clarification as to whether a revolving pool securitization with collateral groups meets the common pool requirement. Commenters did not provide details about these grouping practices, and the agencies believe the use of collateral groups may not satisfy the common pool requirement. If the arrangement were analogous to a construct with multiple revolving pool securitizations being operated out of a single issuing entity, and the sponsor could demonstrate that each group would comply with the rule's requirements on an independent basis, the arrangement could meet the common pool standard. On the other hand, if the arrangement is analogous to a revolving pool securitization in one group and a series trust in another

[83] The agencies are also concerned that the approach suggested by commenters is inconsistent with the rule's approach to the timing of the fair value determination for retained eligible horizontal residual interests under the standard risk retention option, under which the fair value ratio of residual to ABS interests issued is measured at the time of issuance. Although sponsors noted that the terms of a delinked revolving pool securitization transaction include requirements for minimum levels of subordination to be maintained in connection with the maturity and replacement of subordinated interests, these measures do not necessarily ensure equivalent fair value for a replacement subordination interest. Commenters did not suggest any alternatives to address this area of concern.

[84] The agencies made this change, and eliminated language in the definition requiring the issuing entity to be a ''master trust,'' in response to comments indicating sponsors sometimes organize the issuing entity as a different type of legal entity.

[85] Although ''series'' could be considered a term of art in securitization, it is not a defined term in the rule. The rule text in this regard refers to ''more than one series, class, subclass, or tranche.'' Section 5(a) of the final rule. The agencies believe the text is sufficiently flexible to accommodate, regardless of transaction labels used, the concept of a discrete issuance of ABS interests of a certain maturity, albeit one with a renewable or renegotiated maturity, as well as delinked structures. However, in the same vein, the rule's reference to a class, subclass, or tranche, which are terms commonly used to describe subsets within a series, is not an invitation to sponsors to assert that subdivisions of an issuance qualify as multiple issuances for these purposes.

[86] The agencies also recognize that the extent to which the sponsoring organization utilizes investor funding to fund the securitized assets may vary according to business need, as well as the availability of alternate sources of funds at more favorable rates.

[87] In referring to maturities in this aspect of the discussion, the agencies do not focus on legal maturity, or to effective maturity or duration, as those terms are used in finance, but to the actual lifespan of the assets and interests. For example, in many revolving pool securitizations, such as credit card, automobile floor plan, construction loan, and trade receivable deals, the maturity of the securitized assets is so short that the structure is used to lengthen the maturity of the asset-backed securities to attract investors. In other revolving pool securitizations, such as UK residential mortgage deals, the structure is used to create shorter maturity bullet asset-backed securities to attract investors.

group, the arrangement would be extremely unlikely to satisfy the common pool standard. If distributions and losses from any ''group'' are designated to a single outstanding series, the arrangement would not meet the common pool standard.[88] To accommodate the possibility of a multiple group arrangement, the agencies have modified the rule text of the common pool requirement slightly to eliminate the requirement that the common pool collateralize ''all'' series issued by the revolving pool securitization, as well as a similar requirement in the definition of seller's interest. Nevertheless, a sponsor that relies on section 5 of the rule for a multiple group arrangement bears ultimate responsibility to demonstrate full compliance with the rule's common pool requirement.

As discussed above, the reproposal also noted that revolving pool securitizations do not monetize excess spread, and the agencies invited comment as to whether the rule should be modified to expressly prohibit structures that rely on the seller's interest option from issuing senior interest-only bonds or premium bonds.[89] In light of commenters' concerns about the feasibility of incorporating this restriction into a regulatory requirement and attendant grandfathering issues with respect to structures that have classes of bonds previously issued with idiosyncratic interest rates, the agencies are taking a different approach. The agencies have added to the definition of a revolving pool securitization the requirement that the sponsor does not monetize excess spread from its securitized assets. The ability of a sponsor to meet this standard with respect to its outstanding investor ABS interests depends on the facts and circumstances of the issuance, including whether the revolving pool securitization issues ABS interests that price materially above par in light of all the features of the ABS interests and market conditions, or the revolving pool securitization issues ABS interests that pay investors interest on notional principal absent issuance of a corresponding issuance of principal-only bonds to support the revolving pool securitization.

Consistent with the reproposal, the final rule requires the seller's interest to be not less than 5 percent of the aggregate unpaid principal balance of all outstanding investor ABS interests in the issuing entity. The phrase ''all outstanding investor ABS interests issued'' refers to ABS interests issued to persons other than the sponsor and wholly-owned affiliates of the sponsor. Although the reproposal suggested that ABS interests held by the sponsor would still be treated as outstanding investor ABS interests if those asset-backed securities were ''issued under a series,'' the agencies are simplifying the final rule to eliminate this distinction, which could raise associated interpretive issues as to whether certain retained interests met that description. Accordingly, in determining the 5 percent ratio, a sponsor is not required to include in the denominator the amount of ABS interests that are held by the sponsor or its wholly-owned affiliates, but only if the sponsor (or its wholly-owned affiliates) retains them for the life of the ABS interests. This treatment applies for ABS interests held by the sponsor and its wholly-owned affiliates for purposes of complying with the risk retention rule, or held for other reasons.[90] In order to maintain consistency with a sponsor's disclosures as to the manner of its compliance with the seller's interest requirement, which are communicated to investors in connection with the issuance of a series of ABS interests, the sponsor must make a threshold determination as to whether it intends to retain excluded ABS interests for their life and disclose this election to investors. If a sponsor wishes to retain the flexibility to transfer an ABS interest in the future, the sponsor must, from the time of the issuance of the ABS interest onward, include such ABS interest in the denominator.[91]

The agencies have also added language clarifying that, if the transaction documents set minimum required seller's interest as a proportion of the unpaid principal balance of the outstanding investor ABS interests in one or more identified series, rather than all outstanding investor ABS interests of the revolving pool securitization as a whole, seller's interest may be measured on that basis. However, the percentage of each series' specific seller's interest must (when combined with the percentage of securitization-wide seller's interest, if any) equal at least 5 percent other than for any series issued prior to the applicable effective date. For example, the final rule does not permit a sponsor to include in the numerator of the seller's interest ratio a reserve account that only covers shortfalls of principal and interest payments to holders of a specific series of investor ABS interests.

The final rule requires the 5 percent minimum seller's interest test to be determined and satisfied at the closing of each issuance of ABS interests to investors by the issuing entity, and at least monthly. The agencies have made several adjustments to the measurement details, in response to comments. Sponsors must measure the seller's interest at a seller's interest measurement date specified in the transaction documents at least monthly. If the seller's interest does not meet the minimum percentage requirement on any measurement date and the transaction documents specify a cure period, the minimum percentage requirement must be satisfied within the cure period, but no later than one month after the original measurement date.

For purposes of determining the size of the seller's interest at the closing of each issuance of ABS interests to investors, the final rule permits the sponsor to use a specified ''as of'' date or cut-off date for data in establishing the outstanding value of the revolving pool securitization's securitized assets and an ''as-of'' date or cut-off date for data in establishing the value of the revolving pool securitization's outstanding ABS interests. The agencies expect that sponsors of revolving pool securitizations will, as a practical

[88] The use by a revolving pool securitization of excess cash flows resulting from allocations of distributions to one series of ABS interests as credit enhancement to cover shortfalls in periodic interest obligations, periodic losses, and similar exposures experienced by other specified series of ABS interests (but not all other series of ABS interests) does not violate the common pool requirement. The agencies do not believe this sharing of allocations of distributions among ''groups'' of outstanding series raises the same concerns as separate groups of collateral. Similarly, principal accumulation formulas would not violate the common pool requirement. As discussed above, some revolving pool securitizations allocate principal collections from pool assets during an accumulation phase pursuant to a formula that captures all available principal collections from pool assets that are not otherwise needed for other principal accumulation accounts and acquisition of new pool collateral.

[89] Revised Proposal, 78 FR at 57944.

[90] There are several circumstances in which a sponsor might retain additional ABS interests. Investors may not be inclined to purchase investor ABS interests unless the sponsor holds a greater interest in the securitization transaction. The sponsor's cost of funds to place a subordinated tranche of a series may be greater than the sponsor's cost to fund that tranche through other means, or the sponsor's overall cost of funds may be lower than the funding that can be obtained by issuance of a new series. If the ABS interest is being retained by the sponsor as part of its required risk retention pursuant to the rule, the interest is subject to hedging and transfer restrictions of section 12 of the rule.

[91] An ABS interest retained in this manner and that is not being used to satisfy the minimum risk retention requirements under the rule, and that is excluded from the denominator, is not subject to the restrictions of the final rule that apply to ABS interests retained to meet the risk retention obligations under the final rule. For instance, the sponsor would be permitted to hedge the risks related to holding such an interest.

matter, continue their past practice of using cut-off dates or similar dates as the basis for disclosures about the amount of securitized assets held by the issuing entity, and similarly using investor reporting or distribution dates as the basis for disclosures about the amount of outstanding investor ABS interests. The final rule accommodates this, both for disclosure purposes and for determining compliance with the regulatory minimum seller's interest requirement. The sponsor is required to describe its use of specified dates for these purposes in connection with the associated investor disclosures for the issuance of ABS interests by the revolving pool securitization. In addition, in the interests of ensuring sponsors use up-to-date information, the rule requires the specified dates to be no more than 60 days prior to the date of first use with investors. To accommodate revolving pool securitizations that only make investor distributions quarterly (or less frequently), rather than monthly, the final rule permits the specified dates to be up to 135 days prior to the date of first use with investors.[92]

In addition, the final rule's disclosure requirements require the sponsor to provide pre-sale descriptions of the percentage of seller's interest the sponsor expects to retain at closing. To accommodate this, the final rule permits sponsors to describe adjustments to their specified-date data reflecting increases or decreases for additions or removals of assets the sponsor expects to make before the closing date.[93] The sponsor, in describing the amount of additional investor ABS interest that are expected to be added by the securitization transaction, may also describe other adjustments to the issuing entity's outstanding investor ABS interest data resulting from expected increases and decreases of those interests under the control of the sponsor, such as additional issuances, or scheduled principal payments on outstanding investor ABS interests that the sponsor expects will be made before the closing date. If the amount of seller's interest the sponsor determines that it retains at the closing of the securitization transaction is materially different from the amount described in the pre-closing disclosures, the sponsor must disclose the amount as of closing, within a reasonable time after the closing.

Consistent with the reproposal, the seller's interest amount is the unpaid principal balance of the seller's interest in the common pool of receivables or loans. The minimum required seller's interest cannot be less than 5 percent of the aggregate unpaid principal balance of all outstanding investor ABS interests issued by the issuing entity. The agencies have added language clarifying the measurement of this ratio. Consistent with the definition of seller's interest, the final rule also clarifies that the sponsor may not include in the numerator of the seller's interest ratio ineligible assets, or those servicing assets allocated as collateral for a particular series. The agencies have also added language permitting the sponsor to take a deduction from the denominator (the principal of outstanding investor ABS interests) equal to the amount of funds held in a segregated principal accumulation account for the repayment of outstanding investor ABS interests, subject to certain conditions specified in the rule.[94] For securitized assets without a principal or stated balance, such as royalty payments or leases, the amount of the securitized assets is the value of the collateral as determined under the transaction documents for purposes of measuring the seller's interest required for the revolving pool securitization.

The requirements from the reproposal are unchanged with respect to the holding of the seller's interests. The rule permits wholly-owned affiliates of the sponsor to retain the seller's interest (and the horizontal interests described in section 5 of the rule, described below). The agencies decline to permit holding by majority-owned affiliates, as requested by commenters. The agencies are affording the treatment provided to seller's interest in section 5 of the rule because of the special alignment of incentives created by the sponsor's interest in maintaining access to continued funding through the revolving pool securitization, and the agencies seek to maintain this alignment through this stricter holding requirement under the final rule. The final rule includes changes to the other affiliate-holding provisions within section 5 to maintain consistency with this approach. The final rule also clarifies the provisions allowing seller's interest for ''legacy trust'' assets to be held at either the legacy trust level or the issuing entity level. The final rule, like the reproposal, limits the amount of seller's interest that may be held at the legacy trust level to its proportional share of the combined securitized assets of the two trusts. The text has been clarified to indicate that this proportional share is determined based on the principal balance of the securitized assets in each trust. The final rule also clarifies that the proportion of seller's interest held at the legacy trust level must be equal to this proportion.[95] Commenters requested the agencies permit legacy trusts to retain horizontal forms of risk retention at either level, but the comments did not provide details of these structures. Without more details about the structures commenters seek to accommodate, the agencies have not made changes to section 5 of the rule in this regard.

The agencies made changes requested by commenters to allow for dollar-for-dollar offset from the 5 percent seller's interest requirement for funds maintained in a segregated excess funding account that is funded from distributions otherwise payable to the holder of the seller's interest. The agencies expanded the funding trigger requirements for the account to include the sponsor's failure to meet the minimum seller's interest requirement, and the failure to meet other minimum securitized asset balance tests under the transaction documents.[96] The agencies agree with the commenters that losses would not be allocated to an excess funding account, and have removed a *pari passu* requirement on the priority of such distributions to the account.[97] In order to expand the issuing entity's flexibility slightly to hold the account in a form other than cash deposits, the agencies have also decided to add language permitting investments in the same assets permitted for a horizontal

[92] *See supra* note 62.

[93] In providing the sponsor this operational flexibility, the final rule does not allow the sponsor to adjust the asset total for changes other than additions or removals of assets made by the sponsor itself. Accordingly, the rule does not permit the sponsor to adjust the asset total to take into account seasonal changes in borrowers' revolving credit drawdown rates, expected changes in borrower repayment rates, or other estimated factors.

[94] The terms of the securitization documents must prevent funds in the accumulation account from being applied for any purpose other than the repayment of the unpaid principal of outstanding investor ABS, and the funds in the account may only be invested in the types of assets permitted for a horizontal cash reserve account pursuant to section 4 of the rule.

[95] The reproposal indicated that the legacy trust must hold at least that proportion of seller's interest, but also suggested the sponsor would be permitted to hold a greater proportion of seller's interest at the legacy trust. The final rule clarifies that the proportion must be the same.

[96] Commenters described a common test requiring the principal balance of the securitized assets to be not less than the sum of the numerators used for each series' calculation of its seller's interest ratio to allocate principal collections to the investor ABS interests.

[97] As in the reproposal, the account must, in the event of early amortization, pay out to outstanding investor ABS interest holders in the same manner as distributions on the securitized assets.

cash reserve account pursuant to section 4 of the rule.

The final rule retains the reproposal's provisions allowing the sponsor to reduce its seller's interest to a percentage lower than 5 percent to the extent that, for all series of investor ABS interests issued by the revolving pool securitization, the sponsor retains, at a minimum, a corresponding fair value percentage of subordinated risk retention. This treatment is available with respect to the same two forms of subordinated risk retention the agencies included in the reproposal. As discussed in more detail below, the agencies have revised the requirements of each type slightly, in light of sponsor comments stating that existing structures would not be able to comply with the reproposed rule. An example of the reduction in seller's interest permitted by the final rule is as follows: a revolving pool securitization sponsor holds a seller's interest in the issuing entity's common collateral pool equal to 2 percent of the aggregate balance of outstanding investor ABS interests issued by the securitization. The securitization has two outstanding series; for one series the sponsor retains a residual interest in excess interest and fees with a fair value of 5 percent of the fair value of outstanding investor ABS interests in that series, and for the other, the sponsor retains a horizontal interest with a fair value of 3 percent of the fair value of outstanding investor ABS interests in that series. This revolving pool securitization holds adequate risk retention to comply with section 5 of the rule. So long as the structure in this example only holds 2 percent seller's interest, every future series issued to investors will be required to be supported by at least a 3 percent fair value subordinated interest.

For revolving pool securitizations relying on both seller's interest and subordinated risk retention, commenters requested the agencies grandfather all series issued prior to the applicable effective date of the rule with respect to the subordinated portion of risk retention. For example, for a revolving pool securitization in which the sponsor holds 2 percent seller's interest, these commenters urged the agencies to permit the structure to come into compliance with the rule by continuing to maintain the 2 percent seller's interest and supplement it with at least a 3 percent horizontal interest to support each series issued to investors after the applicable effective date of the rule. Commenters said that, unless the agencies permit this grandfathering approach, a revolving pool securitization with less than 5 percent seller's interest would have no option other than to increase its seller's interest to 5 percent. Commenters asserted it was not feasible to grandfather existing series issued before the applicable effective date of the rule with respect to a seller's interest, since a seller's interest is an interest in the securitization's entire collateral pool, and this factor raises serious obstacles to implementing it on a series-by-series basis. The agencies agree that the grandfathering approach requested by commenters should achieve meaningful risk retention in ABS interests issued in a revolving pool securitization after the applicable effective date of the rule, and the approach is reflected in the final rule text.[98]

In the reproposal, the agencies sought to give revolving pool securitizations the above-described offset credit against a seller's interest for two different forms of horizontal risk retention. The first form was based on the sponsor's interest in excess interest and fees, as described above, made available to the sponsor periodically after covering the trust's expenses, interest due on more senior ABS interests in the series for that payment date, and charge-offs for that period that would otherwise be allocated to more senior ABS interests. Some revolving pool securitizations allocate each series its ratable share of interest and fee collections from the pool collateral and apply the interest and fee collections only within each series, while others permit sharing of excess interest and fee collections to cover shortfalls in another series after application of its share of interest and fee collections. The agencies proposed to allow sponsors to use the fair value of this residual ABS interest in excess interest and fees, as a percentage of the fair value of outstanding investor ABS interests, to reduce their 5 percent minimum seller's interest. As discussed above, commenters said they anticipated the burden of calculating the fair value of these excess interest and fees on a monthly basis would be so high that few, if any, sponsors would avail themselves of the option. The agencies note that this is a residual interest comprised of a stream of future cash flows, and no commenter suggested any other reasonable methodology to assign a value to it for purposes of determining the required amount of risk retention. To address this burden, the final rule does not require the sponsor to disclose its fair value determination to investors monthly. The sponsor also must continue to calculate the fair value of the residual ABS interest in excess interest and fees at the same time the sponsor calculates the seller's interest, to verify that it continues to hold at least the minimum required amount of risk retention.[99]

The agencies have made two clarifying changes to the text of the final rule. First, at the request of commenters, the agencies have eliminated the requirement that the sponsor's residual claim to the interest and fee cash flows for any interest payment period be subordinated to all accrued and payable principal due on the payment date to more senior ABS interests in the series for that period. Commenters asserted this requirement was correct for *interest* due (as the rule provides), but not for principal.[100] The agencies have eliminated the ''and principal'' language contained in the interest subordination paragraph, and have also eliminated the requirement that the residual have the most subordinated claim to any part of the series' share of principal repayment cash flows.[101] In addition, the agencies have clarified that, in applying interest and fees to reduce the series' share of

[98] Specifically, section 5(f) of the rule provides that the seller's interest requirement would be reduced by the subordinated portion of risk retention support for all series of ABS interests issued by the revolving pool securitization after the applicable effective date of the rule.

[99] To reduce burden further, the rule permits the periodic determinations of this residual interest's fair value percentage to be made without re-determining the fair value of the outstanding investor ABS interests in the denominator. The sponsor may, at its option, carry forward the fair values of the outstanding investor ABS interests from the determinations made for the closings of the transactions in which those outstanding investor ABS interests were issued (which are likely to be based on observable market data at that time). Only the fair value of the residual ABS interest in the numerator of the ratio needs to be determined every period. The agencies recognize that, for revolving pool securitizations with one or more amortizing series, this approach may result in a larger denominator and thus a larger residual ABS interest in excess interest and fees. The final rule permits a sponsor to elect to make monthly redeterminations of the fair value of such amortizing series in connection with their periodic determinations.

[100] One group of commenters also said the obligation to pay default-rate interest is typically subordinated to payment of the contract-rate interest and coverage for allocated charge-offs. The agencies regard this as desirable in that it uses available excess spread first to protect investors from losses. At any rate, the arrangement described by commenters in this regard means that the sponsor only claims excess interest and fee collections remaining after covering both types of ''interest,'' which is in compliance with the rule text.

[101] Commenters requested the agencies eliminate the separate waterfall requirement from the option, citing concern that single-waterfall revolving pool securitizations could not utilize the structure. Commenters did not elaborate on how the residual ABS interest in excess interest and fees would be separately identified or valued in such an approach. Since the separate waterfall requirement is a central element of the option, the agencies have retained it.

losses for the applicable period, these losses must include charge-offs that were not covered by available interest and fees in previous periods. The agencies believe this clarification is appropriate to prevent sponsors from receiving payments of excess spread on a period-by-period basis for pools that have suffered un-covered losses on securitized assets in previous periods.[102]

The second form of subordinated risk retention the agencies would have recognized in the reproposal for purposes of reducing the required amount of seller's interest would have been an eligible horizontal residual interest the sponsor simultaneously held in the securitization's outstanding series of ABS interests. The reproposal required these interests to meet all the requirements for the standard form of eligible horizontal residual interest pursuant to section 4 of the reproposed rule. Commenters asserted that revolving pool securitizations that retain a residual ABS interest in excess interest and fees could not simultaneously satisfy the requirement pursuant to section 4 that the eligible horizontal residual interest have the most subordinated claim to interest and principal. Commenters said a residual ABS interest in excess interest and fees is typically structured first to apply a series' share of excess interest and fees each period to cover the series' share of trust expenses and the interest due to each tranche of ABS interests in the series; second to apply remaining excess interest and fees to cover charge-offs allocated to more senior ABS interests in the series; and third to make the remainder available to the sponsor (net of portions shared with other series, in some structures). Commenters said that this subordinated interest is typically structured to pay interest to the holder before excess interest and fee collections are applied to cover the series' share of charge-offs. Accordingly, this residual interest would not have the most subordinated claim to interest.[103] The agencies note that, now that the final rule recognizes subordinated forms of seller's interest, the residual interest may not be the most subordinated claim to principal distributions to the sponsor from the seller's interest, depending on the particulars of the transaction.

In order to permit sponsors to offset their seller's interest with either of the two forms of horizontal risk retention included in the reproposal, the agencies have modified the subordination requirements that would be required for eligible horizontal residual interest, to accommodate the issues described in the preceding paragraph. The final rule provides that a sponsor may take the seller's interest offset for ABS interests that would meet the definition of eligible horizontal residual interest in section 2 of the rule but for the sponsor's simultaneous holding of subordinated seller's interests, residual ABS interest in excess interest and fees, or a combination thereof. In connection with this approach, the sponsor's fair value determination for this horizontal residual interest must not incorporate any value attributable to the sponsor's holdings of subordinated seller's interest or residual ABS interest in excess interest and fees.

Under the final rule, if the sponsor is also taking risk retention credit for its residual ABS interest in excess interest and fees, the sponsor may not include any of the interest payments to itself on this offset eligible horizontal residual interest (''offset EHRI'') in determining the fair value of the offset EHRI. Similarly, if the sponsor is taking risk retention credit for subordinated seller's interest that is used to reduce charge-offs that would otherwise be allocated to reduce the principal of the offset EHRI, the sponsor may not include any principal payments on the offset EHRI in determining the fair value of the offset EHRI. The agencies believe this bright-line rule provides an appropriate compromise between flexibility for sponsors and clarity for investors and regulators as to the nature of the risk retention interests upon which a sponsor relies to comply with the final rule.

Under the final rule, if the sponsor seeks to rely on offset EHRI as part of its risk retention interest for purpose of compliance with the rule, any subordinated seller's interest or residual ABS interest in excess interest and fees retained by the sponsor must also comply with the applicable requirements of section 5 of the rule. This is true even if the sponsor is not asserting reliance on these subordinated seller's interests or residual ABS interests in excess interest and fees as part of its retained risk retention interests to comply with the rule.

Commenters said that sponsors sought the ability to continue incorporating subordinated seller's interest or residual ABS interest in excess interest and fees into their deal structures and simultaneously retain a junior bond, while still having the flexibility to choose which combination of those interests the sponsor would use to comply with the risk retention requirements. Commenters placed particular importance on retaining the flexibility to do this without being required to engage in fair value determinations for the interests the sponsor does not count for purposes of regulatory compliance. Taken together, the agencies believe that these rules for offset EHRI provide an appropriate framework to accommodate that flexibility.[104]

The final rule requires the sponsor to make the percentage fair value determination for offset EHRI, and to make investor disclosures, at the same time and in the same manner as is required for the standard form of eligible horizontal residual interest pursuant to section 4 of the rule. Consistent with the treatment of the standard form of eligible horizontal residual interest pursuant to section 4 of the rule, the sponsor is only required to perform the fair value determination for offset EHRI with respect to the initial issuance of the ABS interests supported by the offset eligible horizontal residual interest. The final rule similarly requires a sponsor using a residual ABS interest in excess interest and fees to disclose the fair value of the interest in the same manner as required for eligible horizontal residual interests pursuant to section 4. To accommodate the fluctuating nature of securitized assets and outstanding investor ABS interests present in revolving pool securitizations, the final rule's valuation and disclosure provisions for offset EHRI and residual ABS interests in excess interest and fees allow the use of specific dates for data on securitized assets and outstanding investor ABS interests, and adjustments to these amounts in connection with pre-sale disclosures. These provisions are the same as those governing the determination of minimum seller's interest, as described above.

Consistent with the agencies' reproposal, the final rule also makes

[102] This eliminates possible incentives for sponsors to attempt to cluster charge-offs into particular periods.

[103] Commenters also said the cash flow restrictions in section 4 were not workable for revolving pool securitizations. As discussed elsewhere in this Supplementary Information, these restrictions are not included in the final rule.

[104] As an example, a sponsor could rely on a pari passu seller's interest and supplement it with the fair value of principal payments on an offset EHRI, at the same time the sponsor retained a residual interest in excess spread but did not rely on that interest for purposes of satisfying its risk retention requirements. Or for a revolving pool securitization of assets that do not generate significant excess spread, the sponsor might rely on a subordinated seller's interest and supplement it with the fair value of interest payments on an offset EHRI, since its residual interest in excess interest and fee collections would provide a lesser contribution to satisfying the sponsor's risk retention obligations.

clear that there is no sunset date for revolving pool securitization risk retention interests. The basis for the agencies' decision to propose a sunset date for risk retention was that sound underwriting is less likely to be effectively promoted by risk retention after a certain period of time has passed and a peak number of delinquencies for an asset class has occurred. In the case of a revolving pool securitization, this rationale does not apply, since the sponsor continually transfers additional assets into the common pool of collateral.[105] For a seller's interest, the rule text continues to specify that the seller's interest must be measured and satisfied at least monthly until no ABS interest in the issuing entity is held by any person which is not a wholly-owned affiliate of the sponsor.[106] For other forms of risk retention employed by a revolving pool securitization sponsor, the applicable provision on sunset is in section 12(f) of the rule. Notably, this provision only lifts the transfer and hedging restrictions of section 12 of the rule at ''the latest of'' amortization of the securitized assets to 33 percent of the original balance, amortization of the principal amount of the ABS interests to 33 percent of their original balance, or two years after closing. Since the common pool of securitized assets continually revolves and the ABS interests typically are not paid principal until maturity, neither the securitized assets nor the ABS interests amortize down to 33 percent of the original unpaid balance (absent an early amortization).

Commenters requested several additional changes concerning the rules for holding and measuring a seller's interest. One commenter requested the agencies strike the element of the definition of seller's interest that describes it as an ABS interest. The commenter requested the agencies allow sponsors to hold anything that was the economic equivalent of the seller's interest, regardless of form. The agencies are not making this change because they believe the rule's definition of ''ABS interest'' provides sufficient flexibility, balanced against the agencies' interest in certainty and clarity regarding how a sponsor achieves compliance with the rule. With respect to the form requirements for an ABS interest, the definition applies to any type of interest, whether certificated or uncertificated, and includes beneficial interests and residual interests. This provides flexibility for sponsors and imposes no specific requirements as to form or documentation, but at the same time maintains a basic requirement for the sponsor to be able to demonstrate that the legal source of its entitlement to payments from, and its obligation to share losses of, the securitized assets are consistent with the rule's requirements for a risk retention interest.

Another group of commenters requested the agencies modify the holding requirements for sponsors reducing their 5 percent seller's interest requirement with offsetting horizontal interests. As described above, the sponsor must demonstrate that it holds the offset percentage as a minimum percentage for every series of outstanding investor ABS interests.[107] Commenters requested the agencies permit sponsors to determine they satisfied the requirement on a weighted average basis taken across all outstanding series. The agencies decline to incorporate this approach because it would result in at least some series of outstanding investor ABS interests with less than 5 percent risk retention. Commenters also requested sponsors be permitted to take partial risk retention credit for horizontal interests the sponsor holds jointly with another party, on a pro rata basis. The agencies note this is not permitted for the standard form of eligible horizontal residual interest, and commenters did not provide sufficient justification for treating offset EHRI any differently.

The agencies revised the disclosure requirements of section 5 of the rule in a manner consistent with the agencies' revisions to the disclosure requirements throughout the rule, with appropriate variations for valuation of seller's interest and offsetting subordinated interests as described above.

The reproposal also included provisions clarifying that a master trust entering early amortization and winding down would not, as a result, violate the rule's requirement that the seller's interest be *pari passu.* Commenters requested changes to the details of these provisions, to reflect more accurately the way early amortization triggers are actually structured. In response to commenter concerns, the agencies have revised the rule text to apply when the securitization has entered early amortization, rather than focusing on the technical trigger events that result in an early amortization commencing.[108] Nevertheless, the agencies also believe that the revisions permitting subordination of the seller's interest make this portion of the final rule less significant than it was when the agencies would have required the seller's interest to be *pari passu.*

For servicing advance receivables, the agencies note that the final rule permits sponsors of revolving pool securitizations to rely on subordinated forms of seller's interest to meet their risk retention requirements, which largely addresses the source of the commenters' concerns.

3. Representative Sample

a. Overview of Reproposal and Public Comment

The original proposal would have allowed a sponsor to satisfy its risk retention requirement for a securitization transaction by retaining ownership of a randomly selected representative sample of assets. To ensure that the sponsor retained exposure to substantially the same type of credit risk as investors in the securitized transaction, the sponsor electing to use the representatives sample option would have been required to construct a ''designated pool'' of assets consisting of at least 1,000 separate assets from which the securitized assets and the assets comprising the representative sample would be drawn. The original proposal also would have required a number of other measures in calculating the representative sample to ensure the integrity of the process of selection, including a requirement to obtain a report regarding agreed-upon procedures from an independent public accounting firm.[109]

[105] Even if the pool consists of receivables created by revolving accounts, successful underwriting of revolving account credits is an ongoing process for the life of the credit line.

[106] The agencies have modified the rule text to clarify that holding by an affiliate for these purposes means holding by a wholly-owned affiliate. This is consistent with the other affiliation requirements of section 5 of the rule.

[107] Commenters also expressed the view that the reproposal did not provide sponsors with the flexibility to offset their minimum seller's interest percentage with a form of horizontal risk retention that supported more than one outstanding series. In this regard, the agencies note that the final rule requires the sponsor to satisfy the minimum floor for every series issued after the applicable effective date of the rule, but that it does not require them to hold that risk retention in each series. The rule does not prevent sponsors from incorporating residual ABS interest in excess interest and fees or offset EHRI that are structured to support more than one series, or structured to support delinked structures, so long as the sponsor demonstrates the structure satisfies the rule's requirements as to the terms of those horizontal interests.

[108] The agencies have also eliminated the paragraph limiting the provision to pools of revolving assets. The language was included in the reproposal based on concerns about potential evasive structures, but the agencies have now directly addressed that issue in the discussion of revolving pool securitizations that amortize without issuing a second series of investor ABS interests collateralized by the common pool of assets.

[109] *See* Original Proposal, 76 FR at 24104.

Many commenters opposed the representative sample in the original proposal, noting that it would be impractical to implement this option for a variety of reasons, including that it would be unworkable with respect to various asset classes, would be subject to manipulation, and was too burdensome with respect to its disclosure requirements. Due to these concerns and a conclusion that the representative sample option would likely be too difficult to implement, the agencies did not include a representative sample option in the reproposed rule. Instead, the agencies invited comment on whether a representative sample option should be included as a form of risk retention, and, if so, how should such an option be constructed, and what benefits such an option might provide.

The agencies received several responses to this request for comment. While some commenters were supportive of the reproposal's elimination of the representative sample option, many commenters urged the agencies to reconsider including the option in a simplified form. Several commenters recommended a simplified version of a representative sample option similar to the representative sample option included in the FDIC's safe harbor for securitizations, which (prior to the applicable effective date of the final rule) requires that the retained sample be representative of the securitized asset pool, but does not specify the requirements for establishing that the sample is representative and, accordingly, does not itemize specific items, such as servicing, accountant reports or other requirements.[110] Commenters asserted that the representative sample option is one of the two permitted forms of risk retention under the existing FDIC safe harbor and that the approach has been working effectively for several banks that issue asset-backed securities. One commenter stated that its sponsor members would strongly prefer to have a representative sample method as an alternative option, even if the final rule is more burdensome than they would prefer.

Commenters indicated that the representative sample is one of the alternative methods of risk retention permitted under Article 122a of the European Union's Capital Markets Directive, and that if the representative sample is not included it may place U.S. issuers at a competitive disadvantage against asset-backed securities issuers from outside the United States, and could make it more difficult for global offerings of asset-backed securities originated outside the United States to be sold to investors in the United States.

Many commenters indicated that a revised representative sample option would be particularly useful for automobile loan and lease securitizations. Commenters also stated that the option would be useful more generally for large pools of consumer or retail assets, such as student loans, and for sponsors that do not securitize all of their assets. In order to facilitate use by sponsors for these types of securitizations, commenters generally agreed that the agencies should revise the option so that (i) a sponsor selects a designated pool of assets for securitization (ii) then uses a random selection process to select a 'sample' of assets with an aggregate unpaid principal balance equal to 5 percent of the pool and (iii) that the pool should be sufficiently large to ensure that the sample is representative of the assets in the pool. To accomplish (iii), commenters suggested that a pool size of 5,500 or 6,000 loans would be sufficient to achieve a high confidence level that the sample shares significant asset characteristics with the securitized pool.

A commenter suggested that additional criteria could be added such as documentation of material asset characteristics and a description of the policies and procedures that the sponsor used to ensure that the sample identification process complies with the risk retention requirement. The commenter also recommended that documentation identifying the representative sample be maintained for the same duration required for a vertical risk retention interest and that the assets be excluded from the securitization pool and from any other securitization for such time period. Other commenters favored simpler disclosures, such as a statement that the composition of the sample was prepared in accordance with the rule's requirements, and a description of the method used to randomly select assets.

A few commenters suggested that additional criteria could be added specifically to address smaller pool sizes, such as the criteria above, or a 'resampling' requirement if the sample is not sufficiently similar to the securitized pool. Other commenters expressed the view that a sponsor should not be required to 'rework' the pool based on a post hoc examination of the performance of the sample pool compared to the securitized pool.

b. Response to Comments and Final Rule

Having considered the comments, the agencies have concluded that adopting the recommendations made by commenters would be insufficient to address concerns about the practicality of obtaining an adequate and truly representative sample, while providing sufficient flexibility for use of the option in more than extremely limited scenarios. Furthermore, the agencies concur with commenters' views that, at a minimum, a large number of loans would be required depending on the variability of asset characteristics in order to ensure an adequate sample, which greatly reduces the number of asset classes that would be able to utilize the option.

The agencies do not believe that adopting the disclosure, servicing, and independent review requirements as recommended by commenters would be sufficiently robust to ensure the effectiveness of the representative sample option and to minimize the ability of sponsors to ''cherry pick'' assets favorable to them, which would result in the risk retention sample having a better risk profile than the assets collateralizing the ABS issued to investors. In addition, unless large pools of loans are already largely homogeneous, a random sample will not necessarily be a representative sample. The agencies do not believe that effective pool consistency standards would be any less burdensome or objectionable than the sample validation standards. Even if an approach that met the requirements of section 15G of the Exchange Act could be developed, the agencies acknowledge that the costs of such requirements could be overly burdensome for sponsors. Furthermore, in light of the revisions that have been made to other aspects of the rule, the agencies believe that the final rule's risk retention options should provide a workable risk retention option for various asset classes including auto loan, auto lease, and student loan securitizations. The agencies believe these additional risk retention options will be more cost effective than the representative sample option in the original proposal and will more effectively align the interests of sponsors and investors. Therefore, the final rule does not include a representative sample option.

[110] *See* 12 CFR 360.6.

4. Asset-Backed Commercial Paper Conduits

a. Overview of the Reproposal and Public Comments

As explained in the original proposal and reproposal, ABCP is a type of liability that is typically issued to investors by a special purpose vehicle (commonly referred to as a ''conduit'') sponsored by a financial institution or other sponsor. The commercial paper issued by the ABCP conduit is collateralized by a pool of asset-backed securities, which may change over the life of the entity. Depending on the type of ABCP conduit, the securitized assets collateralizing the ABS interests that support the ABCP may consist of a wide range of assets including securitized automobile loans, commercial loans, trade receivables, credit card receivables, student loans, and other loans. Historically, these programs came about as a way for banks to extend commercial firms credit at a lower cost than bank-funded working capital lines or trade receivable financing. Like other types of commercial paper, the term of ABCP typically is short, and the liabilities are ''rolled,'' or refinanced, at regular intervals. Thus, ABCP conduits generally fund longer-term assets with shorter-term liabilities.[111] During the financial crisis, however, ABCP conduits experienced acute distress, which revealed significant structural weaknesses in certain ABCP conduit structures, particularly those ABCP conduits that did not have 100 percent liquidity commitments, and exposed investors and the financial system to significant risks.[112]

In a typical ABCP conduit, the sponsor approves the originators whose loans or receivables will collateralize the ABS interests that support the ABCP issued by the conduit. Banks can use ABCP conduits that they sponsor to meet the borrowing needs of a bank customer and offer that customer a more attractive cost of funds than a commercial loan or a traditional debt or equity financing. In such a transaction, the customer (an ''originator-seller'') may sell loans or receivables to an intermediate, bankruptcy remote SPV. The credit risk of the loans or receivables transferred to the intermediate SPV then typically is separated into two classes—a senior ABS interest that is acquired by the ABCP conduit and a residual ABS interest that absorbs first losses on the loans or receivables and that is retained by the originator-seller. The residual ABS interest retained by the originator-seller typically is sized with the intention that it be sufficiently large to absorb all losses on the securitized assets.

In this structure, the ABCP conduit, in turn, issues short-term ABCP that is collateralized by the senior ABS interests purchased from one or more intermediate SPVs (which are supported by the subordination provided by the residual ABS interests retained by the originator-sellers). The sponsor of this type of ABCP conduit, which is usually a bank or other regulated financial institution or an affiliate or subsidiary of a bank or other regulated financial institution, also typically provides (or arranges for another regulated financial institution or group of financial institution to provide) 100 percent liquidity coverage on the ABCP issued by the conduit. This liquidity coverage typically requires the support provider to provide funding to, or purchase assets or ABCP from, the ABCP conduit in the event that the conduit lacks the funds necessary to repay maturing ABCP issued by the conduit.

The agencies' original proposal included an ABCP option that incorporated several conditions designed to ensure that the ABCP option would have been available only to the type of single-seller or multi-seller ABCP conduits described above. The proposed ABCP option would only have been available to ABCP conduits that issued ABCP with a maximum maturity at the time of issuance of nine months. Under the original proposal, a sponsor of an ABCP conduit program would have been eligible for the proposed ABCP option if a ''regulated liquidity provider'' (defined in the rule generally to mean banks and certain bank affiliates) provided 100 percent liquidity support to the ABCP conduit and the originator-sellers retained a 5 percent horizontal residual interest in each intermediate special purpose vehicle containing the assets they finance through the ABCP conduit. Under the original proposal, this risk retention option would have been available to ABCP conduits collateralized by ABS interests that were issued or initially sold by intermediate SPVs that sold ABS interests exclusively to ABCP conduits and would not have been available to ABCP conduits that purchased securities in the secondary market or operated securities arbitrage programs.[113]

In the reproposal, the agencies maintained an option tailored for ABCP securitization transactions that retained the basic structure of the original proposal with modifications based in part on comments. The modifications were intended to accommodate certain market practices referred to by commenters, while maintaining a meaningful risk retention requirement. The reproposal would have permitted the sponsor of an eligible ABCP conduit to satisfy its risk retention requirement if, for each ABS interest the ABCP conduit acquired from an intermediate SPV, the intermediate SPV's sponsor (the 'originator-seller' with respect to the ABCP conduit) retained an exposure to the assets collateralizing the intermediate SPV in the appropriate form and amount under the rule, provided that all other conditions to this option were satisfied. The agencies reaffirmed the view expressed in the original proposal that such an approach is appropriate in light of the considerations set forth in section 15G(d)(2) of the Exchange Act.[114]

In response to comments, the reproposal would have included additional flexibility not present in the original proposal to permit affiliated groups of originator-sellers to finance credits through a single intermediate SPV. Under the reproposal, both an originator-seller and a ''majority-owned originator-seller affiliate'' (majority-owned OS affiliate) could have sold or transferred assets that these entities had originated to an intermediate SPV. A majority-owned OS affiliate was defined as an entity that, directly or indirectly, majority controls, is majority controlled by, or is under common majority control with, an originator-seller. For purposes of this definition, majority control would have meant 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. However, consistent with the original proposal, intermediate SPVs would not be permitted to acquire assets from non-affiliates.

The reproposal required the ABCP conduit sponsor to: (i) Approve each originator-seller and majority-owned OS affiliate permitted to sell or transfer

[111] *See* section 9 of the Original Proposal.

[112] Daniel M. Covitz, Nellie Liang, and Gustavo A. Suarez, ''The Evolution of a Financial Crisis: Panic in the Asset-Backed Commercial Paper Market,'' Finance and Economics Discussion Series 2009–36 (Washington: Board of Governors of the Federal Reserve System, August 2009).

[113] Such ABCP conduits purchase securities in the secondary market and typically either lack such liquidity facilities or have liquidity coverage that is more limited than those of the ABCP conduits eligible to rely on this option for purposes of the proposed rule.

[114] *See* Revised Proposal, 78 FR at 57949; Original Proposal, 76 FR at 24107.

assets, directly or indirectly, to an intermediate SPV from which an eligible ABCP conduit acquires ABS interests; (ii) approve each intermediate SPV from which an eligible ABCP conduit is permitted to acquire ABS interests; (iii) establish criteria governing the ABS interests, and the assets underlying the ABS interests, acquired by the ABCP conduit; (iv) administer the ABCP conduit by monitoring the ABS interests acquired by the ABCP conduit and the assets supporting those ABS interests, arranging for debt placement, compiling monthly reports, and ensuring compliance with the ABCP conduit documents and with the ABCP conduit's credit and investment policy; and (v) maintain and adhere to policies and procedures for ensuring that the requirements described above have been met.

The reproposal also permitted there to be one or more intermediate SPVs between an originator-seller and/or any majority-owned OS affiliate and the intermediate SPV that issues ABS interests purchased by the ABCP conduit.[115] The reproposal redefined ''intermediate SPV'' as a direct or indirect wholly-owned affiliate[116] of the originator-seller that is 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.[117] Consequently, an intermediate SPV was permitted to acquire assets originated by the originator-seller or one or more of its majority-owned OS affiliates, or it could also have acquired assets from another intermediate SPV or asset-backed securities from another intermediate SPV collateralized solely by securitized assets originated by the originator-seller or one or more of its majority-owned OS affiliate and servicing assets.[118] ABS interests collateralized by assets not originated by the originator-seller or by a majority-owned OS affiliate would have been ineligible as collateral for the ABCP conduit.

The reproposal also would have relaxed activity restrictions on intermediate SPVs, by permitting an intermediate SPV to sell asset-backed securities that it issues to third parties other than ABCP conduits.[119]

The reproposal would have clarified and expanded (as compared to the original proposal) the types of collateral that an eligible ABCP conduit could acquire from an originator-seller and its majority-owned affiliates.[120] Under the revised reproposal definition of ''eligible ABCP conduit'', an ABCP conduit could acquire any of the following types of assets: (1) ABS interests collateralized by securitized assets originated by an originator-seller or one or more majority-owned OS affiliates of the originator-seller and servicing assets; (2) 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 are transferred to an intermediate SPV in connection with a securitization collateralized solely by such leases originated by an originator-seller or one or more majority-owned OS affiliates and servicing assets; and (3) interests in a revolving master trust collateralized solely by assets originated by an originator-seller or one or more majority-owned OS affiliates and servicing assets.[121] Under the proposal, the ABCP option would have been available only for ABCP conduits that were bankruptcy remote or otherwise isolated from insolvency of the sponsor and from any intermediate SPV. Assets other than the ABS interests and servicing assets, such as loans or receivables purchased directly by an ABCP conduit or loans or receivables acquired by an originator-seller, its majority-owned OS affiliates or an intermediate SPV in the secondary market, would have been expressly disqualified.

The reproposal also would have expanded the risk retention options available to an originator-seller, in its capacity as sponsor of the underlying ABS interests issued by the intermediate SPV, by allowing an eligible ABCP conduit to purchase interests for which the originator-seller or a majority-owned OS affiliate retained risk using the standard risk retention or seller's interest options.

The reproposal also would have required a regulated liquidity provider to enter into a legally binding commitment to provide 100 percent liquidity coverage of all the ABCP issued by the issuing entity and would have clarified that 100 percent 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 percent of the amount of ABCP outstanding plus accrued and unpaid interest. In response to commenters on the original proposal, the reproposal clarified that the required liquidity coverage would not be subject to credit performance of the ABS interests held by the ABCP conduit or reduced by the amount of credit support provided to the ABCP conduit and that liquidity coverage that only funds performing assets will not meet the requirements of the ABCP option.

Consistent with the original proposal, under the reproposal the sponsor of an eligible ABCP conduit would have retained responsibility for ensuring compliance with the requirements of the ABCP option.[122]

With respect to disclosures, the reproposal did not include a requirement that the sponsor of the ABCP conduit disclose the names of the originator-sellers who sponsored the ABS interests held by the ABCP conduit and instead included a requirement that an ABCP conduit sponsor promptly notify investors, the Commission, and its appropriate Federal banking agency, if any, in writing of (1) the name and form of organization of any originator-seller that fails to maintain its risk retention as required and the amount of asset-backed securities issued by an intermediate SPV of such originator-

[115] As indicated in the comments on the original proposal, there are instances where, for legal or other purposes, there is a need for multiple intermediate SPVs.

[116] *See* section 2 of the Revised Proposal (definition of ''affiliate'').

[117] *See* section 2 of the Revised Proposal (definition of ''Intermediate SPV'').

[118] The reproposal required each intermediate SPV in structures with one or more multiple intermediate SPVs that do not issue asset-backed securities collateralized solely by ABS interests to be a pass-through entity that either transfers assets to another SPV in anticipation of securitization (*e.g.,* a depositor) or transfer ABS interests to the ABCP conduit or another intermediate SPV.

[119] As explained in the reproposal, the agencies believe that some originator-sellers operate a revolving master trust to finance extensions of credit the originator-seller creates in connection with its business operations. The master trust sometimes issues a series of asset-backed securities collateralized by an interest in those credits directly to investors through a private placement transaction or registered offering, and other times issues an interest to an eligible ABCP conduit. The reproposal was designed to accommodate such practices.

[120] The purpose of this clarification was to allow originator-sellers certain additional flexibility in structuring their participation in eligible ABCP conduits, while retaining the core principle that the assets being financed have been originated by the originator-seller or a majority-controlled OS affiliate, not purchased in the secondary market and aggregated.

[121] The definition of ''servicing assets'' is discussed in Part II.B of this Supplementary Information. The agencies are allowing an ABCP conduit to hold servicing assets.

[122] In response to commenters on the original proposal who requested that the agencies replace the monitoring obligation with a contractual obligation of an originator-seller to maintain compliance, the agencies noted their belief that the sponsor of an ABCP conduit is in the best position to monitor compliance by originator-sellers and majority-owned OS affiliates.

seller and held by the ABCP conduit; (2) the name and form of organization of any originator-seller or majority-owned OS affiliate that hedges, directly or indirectly through an intermediate SPV, its risk retention in violation of its risk retention requirements and the amount of asset-backed securities issued by an intermediate SPV of such originator-seller or majority-owned OS affiliate and held by the ABCP conduit; and (3) and any remedial actions taken by the ABCP conduit sponsor or other party with respect to such asset-backed securities. Consistent with the original proposal, the reproposal would have required the sponsor of an ABCP conduit to provide to each purchaser of ABCP information regarding the regulated liquidity provider, a description of the liquidity coverage, and notice of any failure to fund. The reproposal also retained the requirement that a sponsor provide information regarding the collateral underlying ABS interests held by the ABCP conduit and entities holding risk retention, as well as a description of the risk retention interests. The reproposal also retained the requirement that a sponsor provide to the appropriate Federal regulators, upon request, all of the information required to be provided to investors, as well as the name and form of organization of each originator-seller or majority-owned OS affiliate retaining an interest in the underlying securitization transactions.[123]

Finally, under the reproposal, the sponsor of an ABCP conduit would have been required to take other appropriate steps upon learning of a violation by an originator-seller or majority-owned OS affiliate of its risk retention obligations, and listed, as examples of steps that may be taken, curing any breach of the requirements, or removing from the eligible ABCP conduit any asset-backed security that does not comply with the applicable requirements.

Many commenters expressed general support for the revisions made to the ABCP option and stated that the reproposal provided significantly more flexibility than the original proposal. However, commenters also indicated that additional revisions would be necessary in order to ensure that the ABCP option is available to the types of ABCP programs predominantly available in the current market.

Many commenters requested that the agencies permit additional forms of risk retention within the ABCP option. Commenters encouraged the agencies to recognize standby letters of credit, guarantees, liquidity facilities, unfunded liquidity, asset purchase agreements, repurchase agreements, and other similar support arrangements and credit enhancements to satisfy the risk retention requirement. Commenters expressed the view that allowing such additional forms of risk retention would reduce the inconsistency between the European Union risk retention regime and the U.S. proposal, thus improving the possibility of cross border offerings.[124] Commenters asserted that these ABCP conduit features serve the purpose of credit risk retention by allocating credit risk between asset originators and ABCP conduit sponsors, and aligning incentives between ABCP conduit sponsors and investors. For example, one commenter asserted that under existing market practice, transferors of assets into ABCP conduits routinely retain credit risk in the financed assets in an amount equal to not less than 5 percent of the related subordinated ABCP notes, so that there is no need for the rule to impose duplicative risk retention requirements on ABCP conduit managers.

Another commenter asserted that the reproposed rule would increase the costs of ABCP conduits and substantially reduce the market for ABCP financing, and that the rules were not necessary to promote high-quality underwriting of ABCP, which the commenter asserted is already present in the multi-seller ABCP conduits operating in the current markets. This commenter proposed that sponsors of ABCP collateralized by originator-seller asset pools that are underwritten to high credit quality standards should be permitted to fund 5 percent risk retention either through a cash reserve or through a cash substitute (*e.g.,* irrevocable unconditional letter of credit or credit facility) and should be permitted to rely on committed liquidity facilities that are limited to financing only performing assets.

One commenter expressed the view that the risk retention requirement should not apply to ABCP conduits collateralized by repurchase agreements because the repurchase agreements provide liquidity. One commenter stated that some conduits do not apply asset collections to the payment of ABCP issued by such conduits but instead, in the ordinary course, pay their maturing notes directly from funds provided by their liquidity support providers. This commenter stated that, although the agencies have to date declined to recognize unfunded loan commitments to ABCP conduits as valid risk retention, a repurchase counterparty is contractually obligated from the outset to repurchase the assets from the ABCP conduit, and therefore retains credit risk throughout the term of the transaction.[125]

Many commenters requested a full exemption from risk retention under section 15G of the Exchange Act for ABCP conduits with certain features or structures. For example, one commenter asserted that fully-supported bank-sponsored conduits should be exempt from risk retention, regardless of whether the conduit satisfied other criteria set forth in the rule, because 100 percent of the credit risk is retained by the bank sponsor, and the only risk to investors would be the risk of the sponsoring institution itself.

Some commenters asserted that arrangers and managers of ABCP conduits are not ''sponsors,'' and claimed that there is no valid basis for imposing risk retention requirements on these parties. One commenter asked for clarification as to who will be deemed a sponsor of ABCP issued by an ABCP conduit. One of these commenters disagreed with the agencies' position that in selecting the assets, one can be characterized as ''transferring'' those assets to the issuer. This commenter expressed the view that the word ''transfer,'' as used in section 15G and in the reproposal, cannot reasonably be interpreted to include a conduit manager's selection of the assets that its conduit will purchase. This commenter cited to case law that the term ''transfer'' should be defined by reference to its ''commonly accepted meaning''; and a conduit manager does not itself sell, assign or deliver any assets to the conduit, so that it has not engaged in a ''transfer.''

Several commenters expressed the view that the proposed nine-month restriction on the maximum maturity at issuance for ABCP would be unnecessarily restrictive. Commenters asserted that while historical commercial paper maturities may have been shorter, many aspects of the international liquidity standards for banking organizations established by the Basel Committee on Banking Supervision's ''Basel liquidity

[123] *See* Revised Proposal, 78 FR at 57948.

[124] The European Union credit risk retention regime consists of Articles 405–410 of the Capital Requirements Regulation developed by the European Banking Authority, and is available at *https://www.eba.europa.eu/regulation-and-policy/single-rulebook/interactive-single-rulebook/-/interactive-single-rulebook/toc/504.*

[125] The agencies do not believe there is sufficient basis to distinguish an ABCP conduit collateralized by repurchase agreements from other issuances of ABS interests. As a result, the sponsor of an ABCP conduit collateralized by repurchase agreements would be required to satisfy the requirements of the final rule.

standards,'' including the liquidity coverage ratio and the proposed net stable funding ratio may combine to push average maturities out further. To address these concerns, commenters suggested that the maximum maturity for ABCP held by an eligible ABCP conduit be extended to 397 days, which is the maximum remaining maturity for securities that are eligible for purchase by money market mutual funds pursuant to Rule 2a–7 under the Investment Company Act of 1940, as amended.[126]

The agencies received several comments regarding the definition of ''eligible ABCP conduit.'' Several commenters expressed concern that limitations on assets that may be acquired by ABCP conduits were too restrictive. Commenters stated that many ABCP conduits hold assets that are not asset-backed securities, such as loans or receivables purchased directly from originators under a deferred purchase price note, which the commenters asserted is a customary structure by which conduits now finance originator-seller's assets, not the originator-seller securitization structure required by the reproposal. Commenters also expressed concern that ABCP conduits often hold asset-backed securities that are acquired from various sources, including other ABCP conduits and in the secondary market. One commenter asserted that there is no need to limit permitted investments of fully supported conduits, because investors in ABCP issued by fully-supported conduits base their investment decisions on the liquidity provider's financial strength and reputation (rather than relying on asset quality). A few commenters requested that the ABCP option be modified to permit originator-sellers to convey to intermediate SPVs, in addition to assets originated by them, assets acquired in business combinations and asset purchases.

Another commenter asserted that the proposed limitation on eligible collateral would not permit conduits to acquire assets through an assignment from another ABCP conduit. One commenter requested that the final rules permit transfers between conduits with a common liquidity provider and transfers of positions between one funding agent/liquidity provider/conduit group and another such group.

Several commenters expressed concern regarding the proposed definition of 100 percent liquidity coverage, noting that a significant percentage of existing conduits are partially-supported or do not have 100 percent liquidity coverage as defined by the proposal. Most of these commenters suggested that the definition of 100 percent liquidity coverage be revised to include coverage in a structure under which the liquidity provider's funding obligation is reduced by non-performing or defaulted assets, if the conduit includes some form of credit enhancement equal to at least 5 percent of the outstanding ABCP. One commenter requested that the agencies align the 100 percent liquidity coverage requirement with the regulatory capital treatment applicable to unfunded credit enhancements under the Basel regulatory capital framework for banking organizations, which generally calculates a banking organization's exposure to an eligible ABCP liquidity facility based on the maximum potential amount that the banking organization could be required to fund given the ABCP program's current underlying assets (calculated without regard to the current credit quality of those assets).

Several commenters interpreted the reproposal's requirement that an eligible ABCP conduit obtain from a regulated liquidity provider a legally binding commitment to provide 100 percent liquidity coverage to all the ABCP issued by the ABCP conduit as limiting an ABCP conduit to one regulated liquidity provider. Commenters opposed the requirement in the definition of ''eligible ABCP conduit'' that requires liquidity support from a single liquidity provider. One of these commenters suggested that, although most fully-supported multi-seller conduits currently have 100 percent liquidity support from an affiliate of the conduit manager, the final rule permit conduits to have multiple liquidity providers.

Other commenters stated that syndication of backstop liquidity is market practice, and that there is no reason to limit the number of liquidity providers. One commenter recommended that the agencies revise the definition of ''eligible ABCP conduit'' to clarify that eligible liquidity facilities may include facilities entered into by an affiliate of a regulated liquidity provider, if the regulated liquidity provider unconditionally guarantees its affiliate's obligations.

Commenters generally supported the proposed definition of majority-owned OS affiliate. One commenter observed that the rule text in the reproposal only referred to the originator-seller as the risk retainer, but does not mention its majority-controlled affiliates. This commenter requested that the final rules conform to the preamble of the original proposal by stating that majority-controlled originator-seller affiliates (including an SPV) can satisfy the originator-seller's risk retention requirements.

The agencies received several comments on the proposed definition of intermediate SPV. One commenter stated that in certain circumstances an intermediate SPV is not a direct or indirect wholly owned affiliate of the originator-seller but instead is an ''orphan'' SPV that is owned by a corporate service provider or a charitable trust.

One commenter stated that it was not clear under the reproposal whether an ABCP conduit sponsor would no longer be able to rely on the option if a single asset held by its conduit does not comply with the rule. This commenter requested that the rule prescribe cure periods (of not less than 30 days) and threshold amounts (1 percent of the conduit's assets), so that the conduit will not be forced to unwind based on a single noncompliant asset.

Commenters raised several concerns with respect to the reproposal's disclosure requirements for the ABCP option. One commenter indicated that the asset disclosures in ABCP programs are collectively negotiated and agreed-upon by ABCP investors and conduit arrangers, and the reproposal's calculation and reporting requirements would deter borrowers from financing assets through ABCP conduits.

One commenter indicated that the scope of the proposed disclosure requirements set forth in section 4(c) of the reproposal is unclear, and the proposed requirement to disclose fair value calculations and supporting information would not be feasible. This commenter said that because the conduits typically treat their extensions of credit as loans for accounting purposes, and do not periodically revalue the assets, a requirement to disclose fair value would not conform to existing accounting practices. This commenter stated that many ABCP financings are revolving transactions in which the principal balance of the outstanding notes may change every business day. This commenter also asserted that, because investors in fully supported conduits do not rely on the market value of the assets in their investment decisions, there would be no need to require fully supported conduits to provide asset-level disclosures. The commenter also asserted that to the extent a conduit finances assets for many different originator-sellers, the volume and frequency of disclosures under this requirement would be substantial and unreasonable. This

[126] *See* 17 CFR 270.2a7.

commenter expressed the view that the agencies should not impose unnecessarily broad disclosure requirements that would result in a narrowing of the short-term financing options available to businesses. Another commenter said that the requirement to report the fair value of each of the conduit's interests is unduly burdensome to a sponsor, given the dynamic nature of a conduit's assets. This commenter proposed that a sponsor be required to report only certain items.

Some commenters stated that investors in ABCP fully supported by liquidity facilities do not want or need disclosure from conduit managers of an originator-seller's failure to comply with risk retention requirements. One of these commenters stated that the disclosure requirement would discourage originators from financing assets through ABCP conduits. This commenter stated that since the reproposal did not generally require sponsors of an ABS interests to notify investors of the failure to comply with risk retention requirements, and it was not clear why this obligation was imposed solely for fully-supported ABCP conduits.

One commenter asserted that a sponsor should not be required to develop separate policies or procedures to actively monitor each originator-seller; instead a sponsor should be allowed to rely on an originator-seller's representations and warranties in satisfying its compliance and monitoring requirements. This commenter also proposed that a sponsor be required to notify only regulators upon the actual discovery or knowledge of an originator-seller's failure to comply.

One commenter asserted that investors have generally not requested any significant changes to ABCP disclosure requirements in recent years, and that reports currently being made contain sufficient information for ABCP investors to monitor their investments, especially since the most important economic factors will continue to be the performance of the assets themselves, the 100 percent liquidity coverage, and (in the case of partially supported ABCP conduits) the sponsor's 5 percent or more credit enhancement—but not continued risk retention on the part of the originator-sellers.

Some commenters requested a complete exemption from the credit risk retention requirements for conduits with underlying assets that were originated before the applicable effective date of the rule that may be securitized through an ABCP conduit. One commenter claimed that it would be impractical to impose credit risk retention on an originator-seller that has already entered into a financing transaction with a conduit, because the conduits would not be able to timely renegotiate terms.

b. Overview of the Final Rule

The final rule includes a specific option for ABCP securitization transactions that retains the basic structure of the reproposed ABCP option, with modifications intended to address issues raised by commenters. As with the reproposal, the final rule provides that an eligible ABCP conduit sponsor will satisfy the base risk retention requirement if, for each ABS interest the ABCP conduit acquires from an intermediate SPV, the intermediate SPV's originator-seller [127] retains an economic interest in the credit risk of the assets collateralizing the ABS interest acquired by the eligible ABCP conduit using either standard risk retention or the revolving pool securitization risk retention option (as revised in the final rule).[128] As noted in the reproposal, the use of the ABCP option by the sponsor of an eligible ABCP conduit does not relieve the originator-seller from its independent obligation to comply with its own risk retention obligations as a sponsor of an ABS interest under the revised proposal, if any. The originator-seller will be the sponsor of the asset-backed securities issued by an intermediate SPV and will therefore be required under the final rule to hold an economic interest in the credit risk of the assets collateralizing the asset-backed securities issued by the intermediate SPV.

Under the final rule, a sponsor of an ABCP conduit is not limited to using the ABCP option to satisfy its risk retention requirements. An ABCP conduit sponsor may rely on any of the risk retention options described in section 4 of the rule, provided it meets the criteria for such option. Consistent with the reproposal, standby letters of credit, guarantees, repurchase agreements, asset purchase agreements, and other unfunded forms of credit enhancement cannot be used to satisfy the risk retention requirement.

In response to comments questioning the application of the rule's requirements to an ABCP conduit arranger or manager, the agencies are affirming their view that an arranger or manager of an ABCP conduit is a sponsor or ''securitizer'' under section 15G of the Exchange Act. The agencies believe this is consistent with part (B) of the definition of securitizer which includes ''a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.'' [129] The arranger or manager of an ABCP conduit typically organizes and initiates the transaction as it selects and approves the originators whose loans or receivables will collateralize the ABS interests that support the ABCP issued by the conduit. It also indirectly transfers the securitized assets to the ABCP issuing entity by selecting and directing the ABCP issuing entity to purchase ABS interests collateralized by the securitized assets. The agencies believe that reading the definition of securitizer to include a typical arranger or manager of an ABCP conduit is consistent with the purposes of the statute and principles of statutory interpretation. Furthermore, the agencies believe that the narrow reading of ''securitizer'' supported by commenters is not consistent with Section 15G and could lead to results that would appear contrary to Congressional intent by opening the statute to easy evasion.

A more detailed discussion of the agencies' interpretation of the term ''securitizer,'' including analysis of the statutory text and legislative history can be found in Part III.B.7 of this Supplementary Information.

The agencies have revised the definition of ''eligible ABCP conduit'' in the final rule to accommodate certain business combinations and to clarify the requirements for the types of assets that can be acquired by an eligible ABCP conduit. Other elements of the definition, such as the requirement that an ABCP conduit must be bankruptcy remote or otherwise isolated for

[127] *See infra* footnote 130.

[128] An originator-seller will be subject to the same requirements and have the same benefits under the risk retention rule as any other sponsor that retains risk, including restrictions on transferring or hedging the retained interest to a third party as applied to sponsors. *See* section 5(b)(1) of the final rule (intermediate SPV's originator-seller to retain an economic interest in the credit risk of the securitized assets in the amount and manner required under section 4 or 5 of the rule). For example, an originator-seller retaining risk in its intermediate SPV in the same amount and manner required under section 4 of the rule, as an eligible horizontal residual interest, would be permitted to transfer that interest to a majority-owned affiliate as permitted under section 3 of the rule, subject to the additional restrictions of section 12 of the rule, but an originator-seller retaining risk in its intermediate SPV in the same amount and manner permitted under section 5 of the rule, as a revolving pool securitization seller's interest, could only transfer it to a wholly-owned affiliate, as required by section 5(e)(1) of the rule. *See infra* note 130 for a discussion of the definition of the term ''originator-seller.''

[129] *See* 15 U.S.C. 78o–11(a)(3)(B).

insolvency purposes from the sponsor of the ABCP conduit and from any intermediate SPV, and that an eligible liquidity provider enter into a legally binding commitment to provide 100 percent liquidity coverage to all the ABCP issued by the ABCP conduit remain unchanged from the reproposal.

The final rule definition of eligible ABCP conduit requires that the ABS interests acquired by the ABCP conduit are: (i) ABS interests collateralized solely by assets originated by an originator-seller and by servicing assets; (ii) special units of beneficial interest (or similar ABS interests) in a trust or special purpose vehicle 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). The ABS interests must be acquired by the ABCP conduit in an initial issuance by or on behalf of an intermediate SPV: (1) Directly from the intermediate SPV, (2) from an underwriter of the ABS interests issued by the intermediate SPV, or (3) from another person who acquired the ABS interests directly from the intermediate SPV. Finally, the rule requires that an eligible ABCP conduit is collateralized solely by ABS interests acquired from intermediate SPVs and servicing assets.

The agencies continue to believe that a limitation on the types of assets that may be acquired by an eligible ABCP conduit is appropriate. Although some commenters suggested eligible ABCP conduits should be permitted to purchase assets directly from originator-sellers under arrangements such as deferred purchase price notes, which commenters argued impose continuing risk of loss on originator-sellers that would be comparable to risk retention, the agencies are not incorporating this approach. The agencies believe such an approach would add complexity to the rule, and that requiring originator-sellers to retain risk in the same way as the rule requires for other securitizers provides investors and regulators with better clarity and transparency as to the nature of the originator-seller's retention of risk in the transaction.

The agencies disagree with commenter assertions that, in the context of ABCP conduits, loans or receivables originated before the applicable effective date of the rule should not be subject to risk retention. Section 15G of the Exchange Act applies to any issuance of asset-backed securities after the effective date of the rules, regardless of the date the assets in the securitization were originated. The agencies note, however, that loans or receivables meeting the seasoned loan exemption in section 19 of the rule would not be subject to risk retention requirements, and an originator-seller that sponsors a securitization of seasoned loans would not need to retain risk with respect to a securitization of such assets under the ABCP option.

With respect to ABS interests, the agencies believe that in certain circumstances described by commenters, acquisition of ABS interests from sources other than an intermediate SPV or originator-seller may be accomplished in a manner consistent with the purposes of section 15G of the Exchange Act. The overview of the final rule discusses two revisions to collateral criteria for eligible ABCP conduits: one that would permit limited transfers between certain ABCP conduits, and another that would permit securitization of assets acquired as the result of certain business combinations.

The agencies are adopting as reproposed the requirements that an ABCP conduit sponsor (i) approve each originator-seller permitted to sell or transfer assets, directly or indirectly, to an intermediate SPV from which an eligible ABCP conduit acquires ABS interests; (ii) approve each intermediate SPV from which an eligible ABCP conduit is permitted to acquire ABS interests; (iii) establish criteria governing the ABS interests, and the assets underlying the ABS interests, acquired by the ABCP conduit; (iv) administer the ABCP conduit by monitoring the ABS interests acquired by the ABCP conduit and the assets supporting those ABS interests, arranging for debt placement, compiling monthly reports, and ensuring compliance with the ABCP conduit documents and with the ABCP conduit's credit and investment policy; and (v) maintain and adhere to policies and procedures for ensuring that the requirements described above have been met.

The final rule retains the concept that a majority-owned affiliate of an originator-seller may contribute assets it originates to the originator-seller's intermediate SPV. To simplify the rule text for most purposes, the final rule consolidates the reproposal's definition of ''majority-owned OS affiliate'' into the definition of originator-seller itself.[130] In response to comments, the agencies seek to clarify that the originator-seller is the sponsor of a securitization transaction in which an intermediate SPV of such-originator-seller issues ABS interests that are acquired by an eligible ABCP conduit, and that the originator-seller may allocate risk retention to its majority owned-affiliates (or wholly-owned affiliates) as permitted in accordance with the sections 3, 4, and 5 of the rule, as applicable. The sponsor of an ABCP conduit must fulfill the compliance requirements of the ABCP option with respect to the originator-seller that is the sponsor of the intermediate SPV.

The agencies have carefully considered commenters' recommendations regarding the definition of 100 percent liquidity coverage and are adopting the rule as proposed. The agencies understand the concern raised by commenters that a significant number of existing partially-supported conduits will likely not be able to use the ABCP option to satisfy the risk retention requirement, because they are covered by a liquidity facility that adjusts the funding obligation of the liquidity provider according to the performance of the assets collateralizing the ABS interests held by the ABCP conduit.[131] However, the agencies observe that a liquidity facility of the type described by commenters, that reduces the obligation of the liquidity provider to provide funding based on a formula that takes into consideration the amount of non-performing assets could serve to insulate the liquidity provider from the credit risk of non-performing assets in the securitization transaction. The ABCP option is designed to accommodate conduits that expose the liquidity provider to the full credit risk of the assets in the securitization, with the expectation that exposure to the credit risk of such assets will provide the liquidity providers with incentive to undertake robust credit underwriting and monitoring.

The final rule adopts as proposed the requirement that a regulated liquidity

[130] In order to provide clarity in maintaining the distinction between originator-sellers and majority-owned originator-seller affiliates, the agencies have included a provision in the definition of ''originator-seller'' indicating that the majority-owned originator-seller affiliate may not be a sponsor of the originator-seller's intermediate SPV.

[131] In response to commenters on the reproposal, the agencies acknowledge that liquidity coverage that does not require the regulated liquidity provider to pay in the event of a bankruptcy of the ABCP conduit would meet the requirements of the ABCP option adopted in the final rule.

provider enter into a legally binding commitment to provide 100 percent liquidity coverage (in the form of a lending facility, an asset purchase agreement, a repurchase agreement, or other similar arrangement) to all the ABCP issued by the ABCP conduit by lending to, purchasing ABCP issued by, or purchasing assets from, the ABCP conduit in the event that funds are required to repay maturing ABCP issued by the ABCP conduit.

While the final rule continues to require that there be only one registered liquidity provider with responsibility to make payment in respect of the commercial paper notes, the regulated liquidity provider is not prohibited from hedging its liquidity obligation or from backstopping the obligation by entering into sub-participations or other arrangements in respect of this commitment, so long as one regulated liquidity provider remains directly responsible to all holders of ABCP issued by the conduit. To the extent that the regulated liquidity provider that provides liquidity support to the ABCP conduit is exposed to the credit risk of the assets covered by such liquidity support, the agencies believe the incentives that encourage robust underwriting remain appropriately aligned.

The agencies continue to believe that unfunded risk retention is not consistent with the regulatory goal of meaningful risk retention. As such, the requirement in the ABCP credit risk retention option for 100 percent non-asset tested liquidity is not a substitute for risk retention by the ABCP sponsor, but rather a recognition of an integral part of the overall ABCP conduit securitization structure. As the liquidity support is not an ABS interest retained to satisfy a risk retention requirement under the rule, the liquidity provider is not subject to the prohibitions on transfer and hedging in section 12 of the rule with respect to the liquidity support.

The agencies were persuaded by commenters views regarding the likelihood that many conduits will need to issue ABCP with a longer maturity in the future in order to accommodate the needs of regulated institutions that are subject to new liquidity requirements under the Basel liquidity standards. Accordingly, the final rule extends the nine month maximum maturity and defines ABCP as asset-backed commercial paper that has a maturity at the time of issuance not exceeding 397 days, exclusive of grace periods, or any renewal thereof the maturity of which is likewise limited.

The agencies did not receive any comments regarding the reproposal's definition of ABCP conduit. Accordingly, as with the reproposal, the final rule defines an ABCP conduit as an issuing entity with respect to ABCP.

In response to comments, the final rule permits eligible ABCP conduits to acquire ABS interests from other eligible ABCP conduits with the same regulated liquidity provider. Under the final rule, an eligible ABCP conduit may acquire an ABS interest from another eligible ABCP conduit if: (i) The sponsors of both eligible ABCP conduits are in compliance with section 6 of the rule; and (ii) the same regulated liquidity provider has entered into one or more legally binding commitments to provide 100 percent liquidity coverage to all of the ABCP issued by both eligible ABCP conduits.

However, because the agencies continue to be concerned about asset aggregators that acquire loans and receivables from multiple sources in the market, place them in an intermediate SPV, and issue interests to ABCP conduits the agencies have declined to extend the ABCP option to ABCP conduits that purchase ABS interests other than in an initial issuance by or on behalf of an originator-seller's intermediate SPV.

In order to accommodate certain market practices, as referred to in the comments to the reproposal, the agencies are revising the definition of ''intermediate SPV'' in the final rule. The final rule revises this provision to include a special purpose vehicle, often referred to as an ''orphan SPV,'' that has nominal equity owned by a trust or corporate service provider that specializes in providing independent ownership of special purpose vehicles, and such trust or corporate service provider is not affiliated with any other transaction parties. For purposes of the final rule, ''owned by a trust'' includes ''held by a trustee in trust'' and ''issued to a trustee.'' In addition, the corporate service provider will not be affiliated solely because it provides professional directors or administrative services to the orphan SPV or the trust. Finally, the nominal equity in the orphan SPV will not be entitled to a share of the profits and losses or any other economic indicia of ownership.

Consistent with the reproposal, the final rule allows an intermediate SPV to sell ABS interests that it issues to third parties other than ABCP conduits. However, the agencies emphasize that, except as otherwise provided for loans or receivables acquired as part of certain business combinations, the ABS interests acquired by the conduit cannot not be collateralized by securitized assets otherwise purchased or acquired by the intermediate SPV's originator-seller, the originator-seller's majority-owned affiliates, or by the intermediate SPV from unaffiliated originators or sellers. Commenters requested the addition of a cure period, expressing concern as to whether a conduit would be considered to be in violation of the rule any time one of its originator-sellers failed to comply, and the agencies have addressed this issue. The final rule includes the reproposal's provisions obligating the sponsor to monitor originator-sellers' compliance, notify investors of any failure of compliance by an originator-seller, and take appropriate steps to cure the breach. A sponsor of an eligible ABCP conduit that notifies investors and takes appropriate steps in accordance with the terms of the rule will be in compliance with its obligations under the rule, and, accordingly, no ''cure period'' is necessary. Although commenters objected to the requirement to identify originator-sellers by name in these circumstances, the agencies believe it is an important part of incentivizing the originator-seller and ABCP conduit sponsor to comply with the requirements of the ABCP option.

The final rule requires an ABCP conduit sponsor to provide, or cause to be provided, certain disclosures to ABCP investors. In response to commenters' concerns, the disclosure requirement requires that the information about the underlying ABS interests be updated at least monthly, rather than updated in connection with each issuance of ABCP. The final rule requires that disclosures be provided before or contemporaneously with the first sale of ABCP to the investor and must be provided on at least a monthly basis to all conduit investors. In order to implement this requirement, the agencies have required that the disclosures to investors must be based on information as of a date not more than 60 days prior to the date of first use with investors in order to accommodate variations in reporting timelines and incorporation of information received from originator-sellers.

The agencies are persuaded by commenters who expressed concern that the reproposal's disclosure requirements for the details of each originator-seller's risk retention interest, together with the same information as the originator-seller would be required to provide direct investors pursuant to the rule, provides more information than necessary. Accordingly, the final rule revises this disclosure to simplify it significantly. The disclosure must

contain the following information as of a date not more than 60 days prior to the date of first use with investors:

(i) The name and form of organization of the regulated liquidity provider that provides liquidity coverage to the eligible ABCP conduit, including a description of the material terms of such liquidity coverage, and notice of any failure to fund;

(ii) The asset class or brief description of the underlying securitized assets;

(iii) The standard industrial category code (SIC Code) for the originator-seller that will retain (or has retained) pursuant to this section an interest in the securitization transaction; and

(iv) A description of the percentage amount of risk retention by the originator-seller, and whether it is in the form of an eligible horizontal residual interest, vertical interest, or revolving pool securitization seller's interest, as applicable, pursuant to the rule.

The final rule also requires that an ABCP sponsor provide, or cause to be provided, upon request, to the Commission and its appropriate Federal banking agency, if any, in writing, all of the information required to be provided to investors, and the name and form of organization of each originator-seller that will retain (or has retained) a rule-compliant interest in the securitization transaction. As investors in ABCP initially will have significantly less information about the risk retention held by the originator-sellers that sponsor ABS interests collateralizing the ABCP than investors in other forms of ABS interests, the requirement that sponsors disclose a breach by an originator-seller will provide them with relevant information about the originator-seller upon the occurrence of a breach.

5. Commercial Mortgage-Backed Securities

a. Overview of the Reproposal and Public Comments

Section 15G(c)(1)(E) of the Exchange Act [132] provides that, with respect to CMBS, the regulations prescribed by the agencies may provide for retention of the first-loss position by a third-party purchaser that specifically negotiates for the purchase of such first-loss position, holds adequate financial resources to back losses, provides due diligence on all individual assets in the pool before the issuance of the asset-backed securities, and meets the same standards for risk retention as the Federal banking agencies and the Commission require of the securitizer. In light of this provision and the historical market practice of third-party purchasers acquiring first-loss positions in CMBS transactions, the agencies proposed to permit a sponsor of ABS interests that is collateralized by commercial real estate loans to meet its risk retention requirements if third-party purchasers acquired eligible horizontal residual interests in the issuing entity.[133] The reproposal would have permitted one or two third-party purchasers to satisfy the risk retention requirement, so long as their eligible horizontal residual interests were *pari passu* with each other, so that neither third-party purchaser's losses were subordinate to the other's losses. The eligible horizontal residual interest held by the third-party purchasers would have been permitted to be used to satisfy the risk retention requirements either by itself as the sole credit risk retained, or in combination with a vertical interest held by the sponsor.

The CMBS risk retention option in the reproposal would have been available only for securitization transactions collateralized solely by commercial real estate loans and servicing assets. In addition, the following eight requirements would have been required to be met:

(1) Each third-party purchaser retains an eligible horizontal residual interest in the securitization in the same form, amount, and manner as would have been required of the sponsor under the horizontal risk retention option;

(2) Each third-party purchaser pays for the first-loss subordinated interest in cash at the closing of the securitization;

(3) No third-party purchaser obtains financing, directly or indirectly, from any other person party to the securitization transaction (including, but not limited to, the sponsor, depositor, or an unaffiliated servicer), other than a person that is a party solely by reason of being an investor;

(4) Each third-party purchaser performs a review of the credit risk of each asset in the pool prior to the sale of the asset-backed securities;

(5) Except for an affiliation with the special servicer in the securitization transaction or an originator of less than 10 percent of the unpaid principal balance of the securitized assets, no third-party purchaser can be affiliated with any other party to the securitization transaction (other than investors);

(6) The transaction documents provide for the appointment of an operating advisor (Operating Advisor), subject to certain terms and conditions;

(7) The sponsor provides, or causes to be provided, to potential purchasers certain information concerning the third-party purchasers and other information concerning the transaction; and

(8) Any third-party purchaser acquiring an eligible horizontal residual interest under the CMBS option complies with the hedging, transfer and other restrictions applicable to such interest under the reproposed rule as if such third-party purchaser was a sponsor who had acquired the interest under the horizontal risk retention option.

Generally, commenters supported the CMBS risk retention option described in the reproposal. One commenter cautioned against further modifications to the proposed CMBS option, expressing its view that CMBS underwriting standards were beginning to deteriorate.

Another commenter, however, pointed out that risk retention is better implemented where the sponsor retains some ''skin in the game.'' This commenter suggested that the rule require the sharing of risk retention between the sponsor and the third-party purchasers. This commenter suggested that third-party purchasers not be allowed to hold more than 2.5 percent of the risk retention requirements, and that they be required to hold the first-loss position for more than 5 years before being allowed to transfer the position even to another qualified third-party purchaser (barring an earlier sunset). Another commenter requested clarification as to whether multiple sponsors can divide a vertical interest among themselves, on a pro rata basis, based on their contribution to the transaction, with no minimum retention for any one sponsor. Another commenter requested clarification as to whether a sponsor holding an eligible vertical interest in a CMBS transaction would need to retain a portion of the eligible horizontal residual interest as part of that vertical interest, expressing the preference of its CMBS sponsor members that the eligible horizontal residual interest not be included as part of the eligible vertical interest.

After considering these comments, the agencies do not believe it is necessary to require that the sponsor retain or share with third-party purchasers the credit risk in CMBS transactions because third-party purchasers, under the framework of the final rule, must hold the risk and independently review each securitized asset. The agencies observe that under the final rule, the

[132] 15 U.S.C. 78o–11(c)(1)(E).

[133] Such third-party purchasers are commonly referred to in the CMBS market as ''B-piece buyers'' and the eligible horizontal residual interest is commonly referred to as the ''B-piece.''

sponsor remains responsible for compliance with the CMBS option and risk retention and must monitor a third-party purchaser's compliance with the CMBS option.[134] The agencies also do not believe it is necessary to limit the amount of risk retention held by the third-party purchaser in an L-shaped structure. This approach provides parties to CMBS transactions with flexibility to choose how to structure their retention of credit risk in a manner compatible with the practices of the CMBS market. Further, consistent with the reproposal, the agencies continue to believe that the interests of the third-party purchaser and other investors are aligned through other provisions of the proposed CMBS option, such as the Operating Advisor provisions and the sponsor's disclosure requirements discussed below. The agencies also do not believe it is necessary to extend the five-year holding period after which the third-party purchaser may transfer the eligible horizontal residual interest to another third-party purchaser. As stated in the reproposal, the agencies selected five years as a holding period that was sufficiently long to enable underwriting defects to manifest themselves. The agencies did not receive sufficient data or information demonstrating that a longer holding period was warranted.

Additionally, the agencies have determined that it would unduly dilute the credit risk being retained in the CMBS transaction if multiple sponsors were allowed to divide the vertical interest. Consistent with the standard risk retention option generally where multiple sponsors are not permitted to divide the requisite 5 percent credit retention among themselves, in a CMBS transaction with multiple sponsors, if any portion of the required 5 percent retention is to be held by a sponsor (*i.e.,* if any portion of the eligible horizontal residual interest is not sold to a qualified third-party purchaser or an eligible vertical interest is being used to meet the 5 percent retention requirement), that portion of the 5 percent required retention must be held by a single sponsor (and its majority-owned affiliates).

As the agencies stated in the reproposal, the eligible horizontal residual interest held by the third-party purchasers can be used to satisfy the risk retention requirements in combination with a vertical interest held by a sponsor. Consistent with this approach, where the eligible horizontal residual interest is held by a third-party purchaser, and the sponsor holds a vertical interest, the sponsor must, as part of that vertical interest, also retain a portion of the eligible horizontal residual interest, as the vertical interest must constitute 5 percent of the cash flows of each tranche, including the eligible horizontal residual interest.[135]

The agencies also received many comments with respect to the more specific aspects of the CMBS option in the reproposal. These comments and the final rule for these aspects of the CMBS option are discussed below.

b. Third-Party Purchasers

i. Number of Third-Party Purchasers and Retention of Eligible Horizontal Residual Interest

While commenters generally supported allowing up to two third-party purchasers to hold risk retention, one commenter recommended expanding the number of third-party purchasers to allow participation by more than two B-piece investors.

Several commenters recommended allowing the third-party purchasers to hold the interests in a senior-subordinated structure, rather than *pari passu,* provided that the holder of the subordinated interest retains at least half of the requisite eligible horizontal residual interest, and that both third-party purchasers independently satisfy all of the requirements and obligations imposed on third-party purchasers. These commenters suggested that a senior-subordinated structure would better allow the market to appropriately and efficiently price the interests in a manner that is commensurate with the risk of loss of each interest, and to address the different risk tolerance levels of each third-party purchaser. One of these commenters asserted that the *pari passu* requirement would reduce the capacity of third-party purchasers to invest in the eligible horizontal residual interest. However, two commenters strongly opposed allowing third-party purchasers to satisfy the risk retention requirements through a senior-subordinated structure, commenting that such a change would significantly dilute and render ineffective the risk retention requirements.

As stated in the reproposal, the agencies provided additional flexibility for the CMBS option by allowing up to two third-party purchasers to satisfy the risk retention requirement. The agencies do not believe it would be appropriate to allow more than two third-party purchasers in a single transaction, because it could dilute the incentives generated by the risk retention requirement to monitor the credit quality of the commercial mortgages in the pool. Similarly, the agencies agree that allowing the third-party purchasers to satisfy the risk retention requirement through a senior-subordinated structure would significantly dilute the effectiveness of the risk retention requirements. Accordingly, the agencies therefore are adopting as proposed the *pari passu* requirement with respect to the retained interests held by third-party purchasers in a CMBS transaction.

ii. Third-Party Purchaser Qualifying Criteria

The agencies did not propose any qualifying criteria for third-party purchasers in the original proposal or the reproposal.

In response, one commenter requested that third-party purchasers be ''qualified'' based on predetermined criteria of experience, financial analysis capability, capability to direct the special servicer, and capability to sustain losses. Another commenter requested that if a third-party purchaser's affiliate contributes more than 10 percent of the securitized assets to a CMBS transaction, that third-party purchaser should be precluded from holding the eligible horizontal residual interest.

Another commenter stated its belief that it is common for several funds within a fund complex that are managed by the same or affiliated investment adviser to purchase eligible horizontal residual interests in the same CMBS transaction and, to be consistent with practice, the definition of third-party purchaser should be expanded to include multiple funds that are managed by the same or affiliated investment advisers.

Consistent with the reproposal, the agencies are not adopting specific qualifying criteria for third-party purchasers. The agencies believe that investors in the business of purchasing first-loss positions or ''B-piece'' interests in CMBS transactions have the requisite experience and capabilities to make an informed decision regarding their purchases. B-piece interests are not offered or sold through registered offerings—typically a B-piece interest will be sold in reliance on Securities Act Rule 144A, which requires purchasers to be qualified institutional buyers. The agencies observed that B-piece CMBS investors are typically real estate specialists who use their knowledge about the underlying assets and mortgages in the pools to conduct

[134] See section 7(c) of the final rule.

[135] If there is no third-party purchaser and the sponsor holds all of the required retention in the form of a vertical interest, the sponsor must hold 5 percent of each tranche including the most subordinated tranche in the structure.

extensive due diligence on new deals. The agencies also observed that the B-piece market has very few participants. According to Commercial Mortgage Alert data, in 2009–2013, there were 38 different B-piece buyers with nine of them participating in 70 percent of CMBS deals. Furthermore, as discussed below, the agencies believe that the reproposed rule's disclosure requirements with respect to the identity and CMBS investment experience of third-party purchasers are sufficient to allow investors in a CMBS transaction to assess the investment experience and other qualifications of third-party purchasers and other material information necessary to make an informed investment decision. If, in the future, the agencies observe adverse changes in the experience and capabilities of third-party purchasers in CMBS transactions, the agencies may consider whether modifications to the rule should be made to address these issues.

Also consistent with the reproposal, the final rule retains the requirement that third-party purchasers be independent from originators of more than 10 percent of the securitized assets. The agencies believe that the independence requirement will help ensure a new review by the third-party purchaser of the underwriting of the securitized loans and do not believe that the requirement will adversely affect the number of third-party purchasers willing to assume the risk retention obligations in CMBS transactions. Last, the agencies are not expanding the definition of third-party purchaser to include multiple funds that are managed by the same or affiliated investment adviser. The agencies introduced the concept of a ''majority-owned affiliate'' in the reproposal, which would permit risk retention to be retained by a third-party purchaser or its majority-owned affiliate. The final rule retains the reproposal's provisions allowing sponsors and third-party purchasers to transfer retained risk to their majority-owned affiliates. The final rule does not allow sponsors or third-party purchasers to transfer retained risk to parties other than majority-owned affiliates, as the agencies believe the rule being adopted today already includes flexibility with respect to risk retention held by an entity that is a majority-owned affiliate of a third-party purchaser, and that further expansion of the definition of third-party purchaser is not necessary and would dilute the risk required to be retained by a sponsor or third-party purchaser.

c. Operating Advisor

i. Applicability of the Operating Advisor Requirement

The reproposal included a requirement that all CMBS transactions that use the third-party purchaser option to satisfy the risk retention requirement must appoint an Operating Advisor that is not affiliated with other parties to the securitization transaction. The reproposal would have prohibited the Operating Advisor from having, directly or indirectly, any financial interest in the securitization transaction, other than fees from its role as Operating Advisor, and would have required the Operating Advisor to act in the best interest of, and for the benefit of, investors as a collective whole.

Multiple commenters expressed support for the Operating Advisor requirement, noting that it was a helpful governance mechanism and reflective of current market practice. One of these commenters advocated expanding the Operating Advisor requirement to all CMBS transactions, and not simply those relying on the CMBS option. Another commenter recommended that the Operating Advisor be prohibited from having any direct or indirect financial interest in, or financial relationship with, the special servicer.

After considering the comments received, the agencies have decided not to expand the Operating Advisor requirement to CMBS transactions that do not rely on the third-party purchaser CMBS option. As stated in the reproposal, the agencies believe that there is generally a strong connection between third-party purchasers and the special exercise of the servicing rights in CMBS transactions. In CMBS transactions where credit risk is being retained by a third-party purchaser, the agencies believe there is a particular need to provide a check on third-party purchasers by limiting their ability to manipulate cash flows through the exercise of the special servicing rights. The agencies are providing this check by requiring an Operating Advisor in CMBS transaction where the third-party purchaser is holding the risk retention. The agencies note that the requirement that there be an Operating Advisor for any transaction relying on the CMBS option means that the Operating Advisor must be in place at any time that a third-party purchaser holds any portion of the required risk retention. Accordingly, whether the B-piece is initially sold to a third-party purchaser or sold to a third-party purchaser after the initial five year holding period expires, the transaction must have an Operating Advisor in place at all times that a third-party purchaser holds any portion of the required risk retention.

Consistent with the reproposal, the agencies are adopting the requirement that the Operating Advisor be a party that is not affiliated with other parties to the securitization transaction, and does not have, directly or indirectly, any financial interest in the securitization transaction other than fees from its role as Operating Advisor. The agencies continue to believe that this requirement sufficiently establishes the independence of the Operating Advisor and protects investors' interests.

ii. Qualifications of the Operating Advisor

The agencies included in the reproposal certain general qualifications for the Operating Advisor. The reproposal would have required underlying transaction documents in a CMBS transaction to provide standards with respect to the Operating Advisor's experience, expertise and financial strength to fulfill its duties and obligations under the applicable transaction documents over the life of the securitization transaction.

One commenter cautioned against the requirement that qualification standards for the Operating Advisor be specified in the transaction documents. This commenter asserted that the requirements must ensure that a sufficient number of qualified and independent Operating Advisors will be available to fill the role. Additionally, this commenter encouraged the agencies to clarify the mechanism by which the acceptability of the Operating Advisor may be determined.

The agencies do not believe that the rule should mandate the mechanism by which the acceptability of the Operating Advisor is determined, but that the CMBS transaction parties should have the flexibility to establish the appropriate standards for the Operating Advisor in each transaction. As a result, the agencies are adopting the qualification requirements as proposed.

iii. Role of the Operating Advisor

Under the reproposal, once the eligible horizontal residual interest held by third-party purchasers reaches a principal balance of 25 percent or less of its initial principal balance, the special servicers would have been required to consult with the independent Operating Advisor in connection with, and prior to, any major investing decisions related to the servicing of the securitized assets. The reproposal would have required that the Operating Advisor be provided with adequate and timely access to

information and reports necessary to fulfill its duties under the transaction documents. It also would have required that the Operating Advisor be responsible for reviewing the actions of the special servicer, reviewing all reports made by the special servicer to the issuing entity, reviewing for accuracy and consistency in calculations made by the special servicer in accordance with the transaction documents, and issuing a report to investors and the issuing entity on the special servicer's performance.

One commenter supported this requirement, but requested that the agencies clarify the scope of the decisions on which the special servicer was to consult with the Operating Advisor's review, and the scope of the reports to be provided to the Operating Advisor. Several commenters requested that the agencies clarify that the calculation of the principal balance could take into account appraisal reductions and realized losses, in order to be consistent with current market practice. Another commenter questioned the usefulness of the consultation requirement, noting that there is no meaningful connection between the 25 percent threshold and the goal of risk retention. This commenter proposed either eliminating this requirement or limiting the consultation right to the period from the closing of the transaction until the holder of risk retention loses control over the special servicing rights. Another commenter believed that the 25 percent threshold should be reduced to 10 percent.

After considering the comments received, the agencies are adopting the proposed consultation requirement, with some modifications in response to comments. For purposes of determining the principal balance, the agencies are clarifying in the final rule that the calculation should be performed in a manner that is consistent with the calculation as permitted under the transaction documents, and take into account any realized losses and appraisal reduction amounts to the extent permitted under the terms and conditions of the transaction documents. In terms of the scope of reports made by the special servicer to the issuing entity that the Operating Advisor must review, the agencies are clarifying in the final rule that the Operating Advisor shall have adequate and timely access to all reports delivered to all classes of bondholders as well as the holders of the eligible horizontal residual interest. Finally, the agencies believe that section 7(b)(6)(iv) of the final rule sufficiently describes the types of decisions that are subject to consultation—specifically, any material decision in connection with the servicing of the securitized assets which includes, without limitation, any material modification or waiver of any provision of a loan agreement, any foreclosure or similar conversion of the ownership of a property, or any acquisition of a property.

iv. Special Servicer Removal Provisions

The reproposal would have required that the Operating Advisor have the authority to recommend the removal and replacement of the special servicer. Under the reproposal, the removal of the special servicer would have required the affirmative vote of a majority of the outstanding principal balance of all ABS interests voting on the matter, and required a quorum of 5 percent of the outstanding principal balance of all ABS interests.

The agencies received many comments with respect to the Operating Advisor's ability to remove the special servicer. Commenters generally supported retaining the Operating Advisor's ability to recommend the replacement of the special servicer, especially when the special servicer had not acted in the best interest of all investors. However, commenters differed on their views of the appropriate voting quorum requirements.

One commenter believed that the special servicer removal provisions should mirror current CMBS transactions, which typically provide that (i) the Operating Advisor may recommend to remove the special servicer only after the most senior tranche of the B-piece has been reduced to less than 25 percent of its initial principal balance, and (ii) removal can only take place if more than 50 percent of the aggregate outstanding principal balance of all classes affirmatively vote for such removal.

One commenter recommended providing Operating Advisors with a safe harbor from liability, except in the case of gross negligence, fraud or willful misconduct, for recommending replacement of the special servicer. This commenter also recommended requiring the maintenance of an investor registry, so that investors can be easily contacted if the Operating Advisor makes a replacement recommendation that requires a vote.

Commenters submitted a wide range of comments on the quorum requirement for removal of the special servicer. Two commenters asserted that the quorum requirement would be more appropriately specified by the underlying transaction documents, rather than in the final rule, in order to accommodate any future changes in the market. One commenter favored a requirement that in order to reach a quorum, no fewer than three unaffiliated investors participate in the vote. Another commenter recommended two options: (i) Increasing the quorum to 15 percent and requiring the participation of three unaffiliated investors, or (ii) increasing the quorum to 20 percent with no minimum unaffiliated investor-voting requirement. This commenter opposed a more substantive increase to the quorum requirement, asserting that it would be nearly impossible for interest holders to remove the special servicer. Both of these commenters recommended adding a provision that specified that the third-party purchaser may not unilaterally re-appoint the original special servicer or its affiliate following a removal and replacement process.

One commenter highlighted a split in views among those parties who contributed to its comments. Some favored increasing the voting quorum requirement to two-thirds of all investors eligible to vote (before the eligible horizontal residual interest has been reduced below 25 percent), and to one-third of all investors eligible to vote (after the eligible horizontal residual interest has been reduced below 25 percent). Others supported a quorum requirement of at least 20 percent, with at least three independent investors participating in the vote.

After considering the comments received, the agencies have decided to permit CMBS transaction parties to specify in the underlying transaction documents the quorum required for a vote to remove the special servicer. However, the transaction documents may not specify a quorum of more than the holders of 20 percent of the outstanding principal balance of all ABS interests in the issuing entity, with such quorum including at least three ABS interest holders that are not affiliated with each other. The agencies believe that this balanced approach provides CMBS transaction parties with the flexibility to establish the quorum required to remove the special servicer in the applicable transaction documents, as is commonly done, while addressing commenter concerns that a quorum requirement of more than 20 percent may make is difficult for interest holders to remove the special servicer.

The agencies do not believe that it would be appropriate to include a safe harbor for the Operating Advisor or a requirement that there be an investor

registry requirement in the final rule since the agencies believe the Operating Advisor's indemnification rights and the trustee's investor communication provisions should be set forth in, and governed by, the transaction documents.

Finally, the agencies agree with comments requesting that the third-party purchaser should not have the unilateral ability to reappoint the original special servicer or its affiliate. The rule requires the replacement of the special servicer following the recommendation of the Operating Advisor and an affirmative vote of the requisite number of ABS holders. The agencies believe that the independence of the Operating Advisor as otherwise required by the final rule sufficiently ensures that the recommendation of the replacement special servicer will be made independent of third-party purchasers, and that the voting and enhanced quorum requirements being adopted today provide additional assurance in this regard. The quorum and voting requirements effectively require that the third-party purchasers not have the unilateral ability to re-appoint the original special servicer or its affiliate.

d. Disclosures

The reproposal would have required the sponsor to provide, or cause to be provided, to potential purchasers and federal regulators certain information concerning the third-party purchasers and other information concerning the CMBS transaction, such as each third-party purchaser's name and form of organization, experience investing in CMBS, and any other information about the third-party purchaser deemed material to investors in light of the particular securitization transaction.

Additionally, it would have required a sponsor to disclose to investors the amount of the eligible horizontal residual interest that each third-party purchaser will retain (or has retained) in the transaction (expressed as a percentage of the fair value of all ABS interests issued in the securitization transaction and the dollar amount of the fair value of such ABS interests); the purchase price paid for such interest; the material terms of such interest; the amount of the interest that the sponsor would have been required to retain if the sponsor had retained an interest in the transaction; the material assumptions and methodology used in determining the aggregate amount of ABS interests of the issuing entity; the representations and warranties concerning the securitized assets; a schedule of exceptions to these representations and warranties; and information about the factors that were used to make the determination that such exceptions should be included in the pool even though they did not meet the representations and warranties.

In addition, the reproposal would have required that certain material information with respect to the Operating Advisor be disclosed in the applicable transaction documents, including, without limitation, the name and form of organization of the Operating Advisor, the qualification standards applicable to the Operating Advisor, how the Operating Advisor satisfies these qualification standards, and the terms of the Operating Advisor's compensation.

The reproposal also would have required the sponsor to maintain and adhere to policies and procedures to actively monitor the third-party purchaser's compliance with the CMBS option, and to notify investors if the sponsor learns that a third-party purchaser no longer complies with such requirements.

The agencies received a few comments regarding the disclosure requirements under the CMBS risk retention option. Two commenters opposed the disclosure of the purchase price paid by third-party purchasers for the eligible horizontal residual interest. These commenters pointed out that such information has traditionally been viewed by all market participants as highly confidential and proprietary, and that the disclosure requirement would deter B-piece buyers from retaining risk. One of these commenters suggested that the issuer or third-party purchaser could instead provide the purchase price to the appropriate regulatory agency on a confidential basis, or disclose only that it has fulfilled the risk retention requirement.

The investment grade investor members of an industry association requested that two additional disclosures be required with respect to the Operating Advisor: (1) Any material conflict of interest or potential conflict of interest of the Operating Advisor; and (2) additional information regarding the formula for calculating the Operating Advisor's compensation.

The agencies are adopting the disclosure requirements for the CMBS option, with some modifications in response to comments. As stated in the reproposal, the agencies believe that the importance of the disclosures to investors with respect to third-party purchasers outweighs potential issues associated with the sponsor or third-party purchaser making such information available. The agencies believe that the disclosure requirements with respect to the identity and experience of third-party purchasers in the CMBS transaction that are being adopted today will alert investors in the transaction as to the experience of third-party purchasers and other material information necessary to make an informed investment decision. In this regard, the rule retains the requirement that the price at which the B-piece is sold be disclosed. Disclosure of the price of the B-piece is consistent with other fair value disclosures. The agencies believe these disclosures are necessary to allow other investors to assess the risk being retained, and that the ability of investors to assess the value of the retained risk outweighs the preferences of some B-piece buyers to keep the price confidential.

With respect to requests that the rule require the disclosure of the method of calculating the Operating Advisor's compensation, the agencies believe the requirement to disclose the terms of the Operating Advisor's compensation already encompasses disclosure as to how such compensation is calculated. Therefore, the agencies believe that no change to the reproposed rule is required in this respect.

With respect to the request that the rule require disclosure of any material conflicts of interest involving the Operating Advisor, the agencies agree that disclosure of any material or potential material conflicts of interest of the Operating Advisor with respect to the securitization transaction should be disclosed. Such disclosure will allow transaction parties to better ensure that the Operating Advisor will act independently. Accordingly, the agencies have added this disclosure requirement to the final rule.

e. Transfer of B-Piece

As discussed above, consistent with the reproposal, the rule allows a sponsor of a CMBS transaction to meet its risk retention requirement where a third-party purchaser acquires the B-piece, and all other criteria and conditions for this CMBS option as described are met.

The reproposal would have permitted, as an exception to the transfer and hedging restrictions in that reproposed rule and section 15G of the Exchange Act, 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 each of the conditions applicable to the initial third-party purchaser under the CMBS option in connection with such purchase. Conditions that an initial third-party purchaser was required to

satisfy at or prior to the closing of the securitization transaction would be required to be satisfied by the transferee at or prior to the time of the transfer to the transferee. The reproposed rule also would have permitted transfers by any such subsequent third-party purchaser to any other purchaser satisfying the criteria applicable to initial third-party purchasers. In addition, if the sponsor retained the B-piece at closing, the reproposed rule would have permitted the sponsor to transfer such interest to a purchaser satisfying the criteria applicable to subsequent third-party purchasers after a five-year period following the closing of the securitization transaction has expired. The reproposed rule also would have required that any transferring third-party purchaser provide the sponsor with complete identifying information as to the transferee third-party purchaser.

Comments on the proposed rule included objections that the five-year holding period was too long and that a sponsor that retained the B-piece at closing should not be required to hold the position for five years before transfer to a qualifying third-party purchaser. Concern was also expressed that imposing the five-year holding period, in tandem with the limitation that there can be no more than two third parties sharing the B-piece on a *pari passu* basis only, could decrease the liquidity of the B-piece and, therefore, disrupt the CMBS market.

Many commenters stated that the five-year transfer restriction period should be reduced, because it would significantly impair the liquidity of CMBS and render the B-piece interests much less desirable. However, these commenters differed on their suggested alternative approaches. One commenter recommended a tiered approach by requiring a third-party purchaser to retain its interest for one year, allowing such third-party purchaser to transfer its interest to a ''qualified transferee'' who meets the same criteria as the third-party purchaser for the following four years, and having no transfer or hedging restrictions after that time. Another commenter asserted that there should be no minimum holding requirement as long as the third-party purchaser transfers the interest to a subsequent third-party purchaser meeting the same qualification requirements as the initial third-party purchaser. Another commenter recommended reducing the transfer restriction period to three years because performance and other pool data are readily available from multiple sources, and investors would have the opportunity to determine loan performance and to identify loans that are not performing as expected.

One commenter suggested reducing the 5 percent risk retention requirement if a five-year holding period is imposed, or allowing the third-party purchaser to transfer to a qualified transferee who meets the same criteria as the third-party purchaser, a qualified institutional buyer under Rule 144A under the Securities Act, or an institutional accredited investor under Rule 501 under the Securities Act. Another commenter recommended allowing sponsors to transfer the retained interest to a qualified third-party purchaser within 90 days after the date of closing of the transaction. One commenter also pointed out the five-year period applicable to holders of eligible horizontal residual interests and contained in section 7 of the reproposal is inconsistent with, and suggested that it be harmonized with, the general transfer restriction period that is contained in section 12 of the reproposal [136] and that it should apply to vertical risk retention in a CMBS transaction, and that both holding periods should be reduced to three years. Several commenters suggested that, if a sponsor holds the B-piece, it should not be subject to the five-year holding period or should be allowed to transfer the B-piece within some short period after the transaction closing. One commenter requested that the final rule state that a sponsor's risk retention obligation be terminated with respect to a CMBS transaction once all of the loans have been defeased.

The final rule, as it relates to the rights to transfer the B-piece, is substantially the same as the reproposal, in which the agencies attempted to balance two overriding goals: (1) Not disrupting the existing CMBS third-party purchaser structure and (2) ensuring that risk retention promotes good underwriting. In formulating the reproposal, the agencies reasoned that, after a five-year period, the quality of the underwriting would be sufficiently evident that the initial third-party purchaser or, if there was no initial third-party purchaser, the sponsor, would suffer the consequences of poor underwriting in the form of a reduced sales price for such interest. The agencies also believe that the initial holder of the B-piece, whether a third-party purchaser or the sponsor, would need to assume that holding the B-piece for a five-year period would result in such holder bearing the consequences of poor underwriting. Thus, by permitting transfer after the five year-period, the agencies do not believe that they are creating a structure which would result in the initial holder being less demanding of the underwriting than if it was required to retain the B-piece until expiration of the full sunset period applicable to CMBS securitizations. In connection with this, the agencies view the requirement (among other conditions) that a subsequent purchaser, like the initial third-party purchaser, conduct an independent review of the credit risk of each securitized asset to be important, as this requirement will emphasize to the initial B-piece holder that the performance of the securitized assets will be scrutinized by any potential purchaser, thus exposing the initial purchaser to the full risks of poor underwriting.

The only change in the final rule from the reproposal is that it allows the risk retention obligation to terminate once all of the loans in a CMBS transaction are fully defeased. A loan is deemed to be defeased if cash or cash equivalents have been pledged to the issuing entity as collateral for the loan and are in such amounts and payable at such times as necessary to timely generate cash sufficient to make all remaining debt service payments due on such loan and the issuing entity has an obligation to release its lien on the loan. Once the collateral securing a loan is replaced with cash or cash equivalent instruments in the full amount remaining due on the loan, thereby defeasing the loan, any risk associated with poor underwriting is eliminated and there is no need to require risk retention to continue to be held.

The standards for the agencies to provide exemptions to the risk requirements and prohibition on hedging are outlined in section 15G. The exemption allowing for a transfer of the B-piece by one qualified third-party purchaser to another qualified third-party purchaser after five years meets these requirements. The agencies decided that unless there was a holding period that was sufficiently long enough to enable underwriting defects to manifest themselves, the original third-party purchaser might not be incentivized to insist on effective

[136] Section 12(f)(1) of the reproposal sets forth the hedging and transfer restriction period that would be generally applicable to risk retention, which is the latest of (i) the date on which the total unpaid principal balance of the securitized assets that collateralize the securitization transaction has been reduced to 33 percent of the total unpaid principal balance of the securitized assets as of the closing of the securitization transaction; (ii) the date on which the total unpaid principal obligations under the ABS interests issued in the securitization transaction has been reduced to 33 percent of the total unpaid principal obligations of the ABS interests at closing of the securitization transaction; or (iii) two years after the date of the closing of the securitization transaction.

underwriting of the securitized assets. The agencies believe that under 15 U.S.C. 78o–11(e)(2), a five-year retention duration helps ensure high-quality underwriting standards for the securitizers and originators of assets that are securitized or available for securitization by forcing sponsors or initial third-party purchasers to bear the risk of losses related to underwriting deficiencies. Furthermore, the agencies believe that this exemption meets the statute's requirement that the exemption encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of consumers and businesses to credit on reasonable terms, or otherwise is in the public interest and for the protection of investors. The approach of requiring the third-party purchaser to hold for at least five years accommodates continuing participation of B-piece buyers in the market, in a way that requires meaningful risk retention as an incentive to good risk management practices by securitizers in selecting assets and addresses specific concerns about maintaining consumers' and businesses' access to commercial mortgage credit.[137]

6. Government-Sponsored Enterprises

a. Overview of the Reproposal and Public Comment

The reproposal provided in section 8 that the full guarantee (for timely payment of principal and interest) by the Enterprises while they operate under the conservatorship or receivership of FHFA with capital support from the United States would have satisfied the risk retention requirements of section 15G of the Exchange Act with respect to the mortgage-backed securities issued by the Enterprises. Similarly, an equivalent guarantee provided by a limited-life regulated entity that succeeds to the charter of an Enterprise, and that is operating under the authority and oversight of FHFA under section 1367(i) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, would have satisfied the risk retention requirements, provided that the entity is operating with capital support from the United States. The reproposal also provided that the hedging and finance provisions would not have applied to an Enterprise while operating under conservatorship or receivership with capital support from the United States, or to a limited-life regulated entity that succeeded to the charter of an Enterprise and is operating under the authority and oversight of FHFA with capital support from the United States. Under the reproposal, a sponsor (that is, an Enterprise) utilizing this option would have been required to provide to investors, in written form under the caption ''Credit Risk Retention'' and, upon request, to FHFA and the Commission, a description of the manner in which it met the credit risk retention requirements.

As the agencies emphasized, if either an Enterprise or a successor limited-life regulated entity began to operate other than as described, the Enterprise or successor entity would no longer be able to avail itself of the credit risk retention option provided by section 8 of the reproposal and would have become subject to the related requirements and prohibitions set forth elsewhere in the reproposal. The reproposal did not alter the approach to the risk retention requirements for the Enterprises in the original proposal.

In explaining their reasons for this approach, the agencies observed that because the Enterprises fully guarantee the timely payment of principal and interest on the mortgage-backed securities they issue, the Enterprises were exposed to the entire credit risk of the mortgages that collateralize those securities.[138] The agencies also highlighted that the Enterprises had been operating under the conservatorship of FHFA since September 6, 2008, and that as conservator, FHFA had assumed all powers formerly held by each Enterprise's officers, directors, and shareholders and was directing its efforts as conservator toward minimizing losses, limiting risk exposure, and ensuring that the Enterprises priced their services to adequately address their costs and risk. Finally, the agencies described how each Enterprise, concurrent with being placed in conservatorship, entered into a Senior Preferred Stock Purchase Agreement (PSPA) with the United States Department of the Treasury (Treasury) and that the PSPAs provided capital support to the relevant Enterprise if the Enterprise's liabilities exceeded its assets under GAAP.[139]

The agencies received only a few comments on proposed section 8, and those commenters generally supported allowing the Enterprises' guarantee to be an acceptable form of risk retention in accordance with the conditions proposed. As a consequence the agencies have decided to adopt section 8 without any change.

While the agencies understand the issues involved with the Enterprises' participation in the mortgage market, the agencies continue to believe that it is appropriate, from a public policy perspective, to recognize the guarantee of the Enterprises as fulfilling their risk retention requirement under section 15G of the Exchange Act, while in conservatorship or receivership with the capital support of the United States.[140] The authority and oversight of the FHFA over the operations of the Enterprises or any successor limited-life regulated entity during a conservatorship or receivership, the full guarantee provided by these entities on the timely payment of principal and interest on the mortgage-backed securities that they issue, and the capital support provided by Treasury under the PSPAs[141] provide a reasonable basis consistent with the goals and intent of section 15G for recognizing the Enterprise guarantee as meeting the Enterprises' risk retention requirement.

For similar reasons, the agencies believe that final rule's restrictions and prohibitions on hedging and transfers of retained interests should not apply to an Enterprise or any successor limited-life regulated entity, as long as the Enterprise (or limited-life successor

[137] While more than one commenter suggested that a sponsor who retains the B-piece be allowed to transfer the B-piece within the five year-period, the agencies do not agree that the sponsor should be treated differently from a third-party purchaser in this regard. The obligation to hold the B-piece for the five year-period is designed to, and will help, ensure high quality underwriting regardless of whether it is held by the sponsor or a third party.

[138] *See* Original Proposal, 76 FR at 24111–24112; Revised Proposal, 78 FR at 57959–57961.

[139] Under each PSPA as amended, Treasury purchased senior preferred stock of each Enterprise. In exchange for this cash contribution, the liquidation preference of the senior preferred stock that Treasury purchased from the Enterprise under the respective PSPA increases in an equivalent amount. The senior preferred stock of each Enterprise purchased by Treasury is senior to all other preferred stock, common stock or other capital stock issued by the Enterprise.

Treasury's commitment to each Enterprise is the greater of: (1) $200 billion; or (2) $200 billion plus the cumulative amount of the Enterprise's net worth deficit as of the end of any calendar quarter in 2010, 2011 and 2012, less any positive net worth as of December 31, 2012. Under amendments to each PSPA signed in August 2012, the fixed-rate quarterly dividend that each Enterprise had been required to pay to Treasury was replaced, beginning on January 1, 2013, with a variable dividend based on each Enterprise's net worth, helping to ensure the continued adequacy of the financial commitment made under the PSPA and eliminating the need for an Enterprise to borrow additional amounts to pay quarterly dividends to Treasury. The PSPAs also require the Enterprises to reduce their retained mortgage portfolios over time.

[140] *See* Revised Proposal, 78 FR at 57960.

[141] By its terms, a PSPA with an Enterprise may not be assigned, transferred, inure to the benefit of, any limited-life, regulated entity established with respect to the Enterprise without the prior written consent of Treasury.

entity) is operating consistent with the conditions set out in the rule. In the past, the Enterprises have sometimes acquired pool insurance to cover a percentage of losses on the mortgage loans comprising the pool.[142] FHFA also has made risk-sharing through a variety of alternative mechanisms a major goal of its Strategic Plan for the Enterprise Conservatorships.[143] Because each Enterprise, while in conservatorship or receivership and operating with capital support from the United States, will need to fully guarantee, and hold the credit risk on, the mortgage-backed securities that it issues for the provisions of section 8 of the rule to apply, the prohibition on hedging the credit risk that a retaining sponsor is otherwise required to retain would have limited the ability of the Enterprises to acquire such pool insurance in the future or take other reasonable actions to limit losses that would otherwise arise from the Enterprises' full exposure to the credit risk of the securities that they issue.

If any of the conditions in the rule cease to apply, an Enterprise or any successor organization will no longer be able to rely on its guarantee to meet the risk retention requirement under section 15G of the Exchange Act and will need to retain risk in accordance with one of the other applicable sections of this risk retention rule. Because section 8 of the rule applies only so long as the relevant Enterprise operates under the authority and control of FHFA and with capital support from the United States, the agencies continue to believe that the rule's approach with regard to the Enterprises' compliance with the risk retention requirement of section 15G of the Exchange Act is consistent with the maintenance of quality underwriting standards, in the public interest, and consistent with the protection of investors.[144]

The agencies recognize ongoing activity related to reform of the Enterprises, and expect to revisit and, if appropriate, modify this and other provisions after the future of the Enterprises and of the statutory and regulatory framework for the Enterprises becomes clearer. The agencies will continue to consider the impact of potential arbitrage between various markets and market participants, and in particular between the Enterprises and the private securitization markets, and whether adjustments should be made to enhance investor protection and financial stability.

7. Open Market Collateralized Loan Obligations

a. Background

A CLO is an asset-backed security that is typically collateralized by portions of tranches of senior, secured commercial loans or similar obligations of borrowers who are of lower credit quality or that do not have a third-party evaluation of the likelihood of timely payment of interest and repayment of principal. As discussed in the reproposal, commenters distinguished between two general types of CLOs: open market CLOs and balance sheet CLOs. As described by commenters, a balance sheet CLO securitizes loans already held by a single institution or its affiliates in portfolio (including assets originated by the institution or its affiliate) and an open market CLO securitizes assets purchased on the secondary market, in accordance with investment guidelines.

CLOs are organized and initiated by a CLO manager usually when the CLO manager partners with a structuring bank that assists in financing asset purchases that occur before the legal formation of the CLO.[145] After the terms of a CLO transaction, including investment guidelines, are agreed upon with key investors, the CLO manager will usually have sole discretion under the governing documents to select portions of tranches of syndicated commercial loans on the primary or secondary market to be acquired by the CLO in compliance with the investment guidelines. An SPV (issuing entity) is formed to issue the asset-backed securities collateralized by commercial loans that the CLO manager has selected and directed the CLO issuing entity to purchase. The CLO manager retains the obligation to actively manage the asset portfolio, in accordance with the investment guidelines, and earns management fees and performance fees [146] for management services provided.

CLOs are a type of CDO. Both are organized and initiated by an asset manager that also actively manages the assets for a period of time after closing in compliance with investment guidelines. Typically, both CLOs and CDOs are characterized by relatively simple sequential pay capital structures and significant participation by key investors in the negotiation of investment guidelines.

As discussed in the reproposal and below, the agencies believe that the risk retention rules apply to CLOs because CLO managers clearly fall within the statutory definition of ''securitizer'' set forth in Exchange Act section 15G. Moreover, the agencies believe it is consistent with the purpose of section 15G of the Exchange Act and principles of statutory interpretation to apply the risk retention rules to CLOs. There is no indication that Congress sought to exclude any specific type of securitization structure from the requirements of section 15G. Other than mandating specific types of exemptions based on underwriting quality and for securitizations involving certain public entities,[147] Congress directed the agencies to apply risk retention generally with respect to all asset-backed securities. Subject only to specific limitations, authority to determine other exemptions was left to the implementing agencies.

Moreover, contrary to commenters' suggestions, as discussed below, developments in the CLO and leveraged loan market suggest that CLOs present many of the same incentive alignment and systemic risk concerns that the risk retention requirements of section 15G were intended to address. CLO issuance has been increasing in recent years.[148] Paralleling this increase has been rapid growth in the issuance of leveraged loans,[149] which are the primary assets purchased by most CLOs. Heightened activity in the leveraged loan market has been driven by search for yield and a corresponding increase in risk appetite by investors.[150] The agencies note that there is evidence that this increased activity in the leveraged loan market has coincided with widespread loosening of underwriting standards.[151] In fact, a recent review of a sample of leveraged loans by the Federal banking agencies found that forty-two percent of leveraged loans examined were criticized by examiners.[152] The agencies

[142] Typically, insurers would pay the first losses on a pool of loans, up to 1 or 2 percent of the aggregate unpaid principal balance of the pool.

[143] *See, e.g.,* FHFA 2012 Report at 7–11; FHFA 2013 Report at 7–11.

[144] *See* Original Proposal, 76 FR at 24112; Revised Proposal 78 FR at 57961.

[145] Board of Governors of the Federal Reserve System, *Report to the Congress on Risk Retention* 22 (Oct. 2010).

[146] In many cases, a portion of the manager's fees are subordinated or contingent upon asset performance.

[147] 15 U.S.C. 78o–11(e).

[148] *Monetary Policy Report,* Board of Governors of the Federal Reserve System, at 23 (July 2014).

[149] *Id.* at 22; *Semiannual Risk Perspective: Spring 2014,* Office of the Comptroller of the Currency, at 29 (June 2014).

[150] *Monetary Policy Report,* at 1–2, 22.

[151] *Id.; Semiannual Risk Perspective: Spring 2014,* at 5.

[152] *Shared National Credits Program: 2013 Review,* Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, at 3 (September 2013) (''A focused review of leveraged loans found material widespread weakness in underwriting practices, including excessive

believe that increases in the origination and pooling of poorly underwritten leveraged loans could expose the financial system to risks.[153] The Federal banking agencies have been monitoring this market closely and have responded to concerns by issuing updated leveraged lending supervisory guidance, which outlines principles related to safe and sound leveraged lending activities, including expectations that banks and thrifts exercise prudent underwriting standards when originating leveraged loans, regardless of intent to hold or distribute them.[154] As discussed in more detail below, these developments in the leveraged loan and CLO market represent similar dynamics to issues in the originate-to-distribute model that were a major factor in the recent financial crisis and that section 15G was intended to address.

For these reasons, and others discussed below, the agencies believe it is appropriate to apply risk retention rules to open market CLOs as well as balance sheet CLOs.

b. Overview of Original Proposal and Reproposal

In the original proposal, the agencies observed that 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 deposited in the CLO structure.[155] Accordingly, the original proposal would have required the CLO manager to satisfy the minimum risk retention requirement for each CLO securitization transaction that it managed by holding a sufficient amount of standard risk retention. The original proposal did not include a form of risk retention designed specifically for CLO securitizations.

As discussed in the reproposal, many commenters on the original proposal raised concerns regarding the impact of the proposal on open market CLOs. Some commenters asserted that most asset management firms currently serving as open market CLO managers do not have the balance sheet capacity to fund 5 percent horizontal or vertical slices of the CLO. They asserted that imposing standard risk retention requirements on these managers could cause independent CLO managers to exit the market or be acquired by larger firms. According to these commenters, the resulting erosion in market competition could increase the cost of credit for large companies that are of lower credit quality or that do not have a third-party evaluation of the likelihood of timely payment of interest and repayment of principal and that are represented in CLO portfolios above the level that otherwise would be consistent with the credit quality of these companies.

Certain commenters also asserted that open market CLO managers are not ''securitizers'' under section 15G of the Exchange Act and, therefore, the agencies do not have the statutory authority to subject them to risk retention requirements. These commenters asserted that CLO managers are not ''securitizers'' as defined in section 15G of the Exchange Act because they do not own, sell, or transfer the loans that comprised the CLO's collateral pool, but only direct which assets would be purchased by the CLO issuing entity.

In the reproposal, the agencies discussed these comments and explained that the definition of ''securitizer'' under section 15G of the Exchange Act applied to open market CLO managers.[156] To help address concerns raised by commenters to the initial proposal, the agencies proposed an alternative method for risk retention compliance for CLOs that the agencies believed would be consistent with the purposes of risk retention. This alternate approach would be available under the reproposal to an open market CLO, the assets of which consist primarily of portions of senior, secured syndicated loans acquired by the issuing entity directly from sellers in open market transactions and servicing assets, and that holds less than 50 percent of its assets by aggregate outstanding principal amount in loans syndicated by lead arrangers that are affiliates of the CLO or CLO manager or originated by originators that are affiliates of the CLO or CLO manager (lead arranger option).

Under the reproposal, as an alternative to the standard options for vertical or horizontal risk retention, the sponsor of an open market CLO could avail itself of the lead arranger option only if, among other requirements: (1) The CLO did not hold or acquire any assets other than CLO-eligible loan tranches (discussed below) and servicing assets (as defined in the reproposed rule); (2) the CLO did not invest in ABS interests or credit derivatives (other than permitted hedges of interest rate or currency risk); and (3) all purchases of assets by the CLO issuing entity (directly or through a warehouse facility used to accumulate the loans prior to the issuance of the CLO's liabilities) were made in open market transactions on an arm's length basis. In addition, to be eligible for the option, the governing documents of the open market CLO would have to require, at all times, that the assets of the open market CLO consist only of CLO-eligible loan tranches and servicing assets.

Under the reproposal's lead arranger option, a term loan of a syndicated credit facility to a commercial borrower would have qualified as a CLO-eligible loan tranche if the firm serving as lead arranger for the term loan tranche were to retain at least 5 percent of the face amount of the term loan tranche. The lead arranger would have been required to retain this portion of the loan tranche until the repayment, maturity, involuntary and unscheduled acceleration, payment default, or bankruptcy default of the loan tranche. This requirement would have applied regardless of whether the loan tranche was purchased on the primary or secondary market, or was held at any particular time by an open market CLO, and was designed to allow meaningful risk retention to be held by a party that has significant control over the underwriting of assets that are typically securitized in CLOs, without causing significant disruption to the CLO market.

In order to ensure that a lead arranger retaining risk had a meaningful level of influence on loan underwriting terms, the reproposal would have required that the lead arranger be identified in the legal documents governing the origination, participation or syndication of the syndicated loan or credit facility and that such documents include covenants by the lead arranger that it will fulfill the requirement to retain a minimum of 5 percent of the face amount of the CLO-eligible loan tranche. The lead arranger also would be required to take on an initial allocation of at least 20 percent of the face amount of the broader syndicated loan or credit facility, with no other member of the syndicate assuming a larger allocation or commitment. Additionally, a retaining lead arranger would have been required to comply with the same sales and hedging restrictions as sponsors of other securitizations until the repayment, maturity, involuntary and unscheduled acceleration, payment default, or bankruptcy default of the loan tranche. Voting rights within the broader

leverage, inability to amortize debt over a reasonable period, and lack of meaningful financial covenants.'').

[153] *See, e.g., Semiannual Risk Perspective: Spring 2014,* at 8.

[154] *See* ''Interagency Guidance on Leveraged Lending,'' Final Supervisory Guidance, 78 FR 17766 (March 22, 2013), at *http://www.gpo.gov/fdsys/pkg/FR-2013-03-22/pdf/2013-06567.pdf* (Leveraged Lending Guidance).

[155] *See* Original Proposal, 76 FR at 24098 n. 42.

[156] *See* 2013 Reproposal, 78 FR at 57962.

syndicated loan or credit facility would also have to be defined in such a way that holders of the ''CLO-eligible'' loan tranche had, at a minimum, consent rights with respect to any material waivers and amendments of the legal documents governing the underlying CLO-eligible loan tranche. Additionally, the pro rata provisions, voting provisions, and security associated with the CLO-eligible loan tranche could not be materially less advantageous to the holders of that tranche than the terms of other tranches of comparable seniority in the broader syndicated credit facility.

Under the reproposal's lead arranger option for open market CLOs, the sponsor would have been required to disclose a complete list of every asset held by an open market CLO (or before the CLO's closing, in a warehouse facility in anticipation of transfer into the CLO at closing). This list would have been required to include the following information: (i) The full legal name and Standard Industrial Classification category code of the obligor of the loan or asset; (ii) the full name of the specific CLO-eligible loan tranche held by the CLO; (iii) the face amount of the CLO-eligible loan tranche held by the CLO; (iv) the price at which the CLO-eligible loan tranche was acquired by the CLO; and (v) for each loan tranche, the full legal name of the lead arranger subject to the sales and hedging restrictions. Second, the sponsor would have been required to disclose the full legal name and form of organization of the CLO manager. This information would have been required to be disclosed a reasonable period of time prior to the sale of the asset-backed securities in the securitization transaction (and at least annually with respect to information regarding the assets held by the CLO) and, upon request, to the Commission and the sponsor's appropriate Federal banking agency, if any. Further, the lead arranger and CLO manager would be required to certify or represent as to the adequacy of the collateral and the attributes of the borrowers of the senior, secured syndicated loans acquired by the CLO and certain other matters.

c. Overview of Public Comments

The agencies received many comments asserting that the proposed options for open market CLOs would be unworkable under existing CLO practices and would lead to a significant reduction in CLO offerings and a corresponding reduction in credit to commercial borrowers. These commenters asserted that the likelihood of a significant number of lead arrangers retaining 5 percent risk retention (in any of the forms permitted by the rule) would be remote and only the largest CLO managers would be able to finance the proposed risk retention requirement through the standard risk retention option. While larger managers might have sufficient financing, several commented that the risk retention requirements would make the management of CLOs less profitable and might cause many managers to decrease their activity in the market. One commenter highlighted a recently issued paper by the Bank of England and the European Central Bank to suggest that risk retention rules in Europe that apply to CLO managers have contributed to a reduction in European CLO issuance.[157] Several commenters asserted that if the risk retention requirement causes a reduction in participation by open market CLOs in the leveraged loan market, some of the resulting reduced credit availability would be replaced by non-CLO credit providers, but cost of capital and instability in the market would increase.

Some commenters expressed specific concerns about the proposed lead arranger option. These commenters stated that having lead arrangers hold a portion of the loan would increase the costs of arranging loans, thus restricting the availability of credit to borrowers or increasing the cost of credit to borrowers. In addition, commenters expressed concern that few loans would satisfy the definition of ''CLO-eligible loan tranche.'' Furthermore, they asserted that the additional voting rights required by the reproposal would be administratively unworkable and commercially unacceptable. Several commenters also raised concerns that the proposed option would expose the arranger to potential liability and litigation risks that arrangers should not be expected, and would not be willing, to assume. Commenters raised particular concern about the requirement that a lead arranger represent that the loans and collateral meet specified criteria. They asserted that such a representation would require the lead arranger to make subjective and difficult determinations regarding the adequacy of collateral, and the sufficiency of the security interest in the collateral and certain other matters, and could expose the lead arranger to potential liability.

Another concern raised by several commenters was that the proposed lead arranger option would prevent prudent risk management practices and thus invite criticism from lead arrangers' bank regulators because the hedging restriction would prohibit arrangers from actively managing the risks and disposing of loan assets in response to market conditions, and would limit lead arrangers' capacities to provide other forms of credit to borrowers. Further, commenters stated that use of the option would increase the capital and FDIC assessment charges for lead arranger banks and cause corresponding increases in the pricing of CLO-eligible tranches. In addition, some commenters raised concerns that the proposed option's creation of both CLO-eligible loans and non-eligible loans with otherwise comparable characteristics would distort and restrict the initial syndication process and the secondary loan market, as the secondary loan market would place a premium on CLO-eligible loans and liquidity related to non-eligible loans would be reduced. Relative to a ''normal'' market, both types of loans would be less liquid because they would each reflect a smaller, divided market.

As discussed in Part B.1 of this Supplementary Information, a number of commenters expressed concern that the proposed restriction on cash flow distributions to eligible horizontal residual interests would make the eligible horizontal residual interest an unworkable option for CLOs. They suggested that the cash flow distribution restriction would significantly reduce returns to equity investors, making CLOs unattractive investments and cause dramatically reduced CLO issuances. Further, a few commenters supported a phase-in period while markets adjust to the final rule or a grandfathering for certain legacy CLOs. Two commenters also recommended that the risk retention rules follow the European risk retention rules with respect to CLOs.[158] One such commenter expressed concerns that inconsistent regulations would cause bifurcation of the CLO market and substantially reduce market liquidity. Further, a few commenters asserted that the costs of imposing risk retention on CLO managers exceeds the benefits and that the agencies have not performed an adequate economic analysis in connection with the CLO option.

[157] *The Case for a Better Functioning Securitisation Market in the European Union,* Bank of England and the European Central Bank (May 2014), available at *https://www.ecb.europa.eu/pub/pdf/other/ecb-boe_case_better_functioning_securitisation_marketen.pdf.*

[158] The agencies note that Articles 404–410 of the EU Capital Requirements Regulation significantly amended Article 122a of the European Union's Capital Markets Directive with respect to the use of third parties to retain risk.

Some commenters continued to assert that open market CLO managers are not ''securitizers'' and are, therefore, not subject to section 15G. These commenters asserted that under the plain language of the statute, CLO managers cannot ''sell'' or ''transfer'' the assets securitized through the CLO because they do not own, possess, or control the assets. Additionally, commenters asserted that the CLO manager acts as an agent to the CLO issuing entity in directing the purchase of assets, so it could not sell or transfer the assets to a third party to meet the definition, because it would be equivalent to selling or transferring the assets to itself. They asserted that the use of ''indirectly'' in the definition of securitizer was intended to prevent the party that originates a loan from avoiding risk retention obligations by passing the loan through an associated intermediary that organized and initiated the securitization.

The commenters also asserted that the interpretation is not supported by the legislative history or statutory purpose of the Dodd-Frank Act. They suggested that Congress primarily intended to address problems with the originate-to-distribute model and transparency issues in securitization transactions, but open market CLOs differ from the originate-to-distribute model and are more transparent than the products Congress sought to regulate. The commenters stated that in the originate-to-distribute model originators receive significant up-front fees for originating loans, which they transfer into securitization pools to promote the business of creating additional loans. They asserted that CLOs differ from this model because the primary purpose of CLOs is to provide investors with the ability to gain exposure to commercial loans on a diversified basis, not to finance the creation of financial assets. They also asserted that, unlike originators in the originate-to-distribute model, who receive their compensation by originating and transferring the assets to securitization pools, the bulk of CLO managers' compensation is based on performance of the securitized assets in the CLO. Regarding the transparency issues that Congress sought to address, the commenters suggested that the primary concern of Congress was to apply risk retention to highly opaque and complex products like re-securitizations of asset-backed securities. These commenters asserted that CLOs are more transparent than such products because they contain fewer, larger, loans and the obligors of such loans are typically known corporations on which investors can perform extensive due diligence, and the loans are traded in a liquid market that assesses risks and underwriting quality.

In addition to the above comments, some commenters requested alternative options for meeting risk retention or that the agencies provide an exemption from risk retention for managers of open market CLOs where certain criteria would be met because of the nature and characteristics of open market CLOs. In this regard, commenters asserted that open market CLOs operate independently of originators and are not part of, and do not pose the same risks as, the originate-to-distribute model. They also suggested that CLO managers' interests are fully aligned with CLO investors' interests because CLO managers bear significant risk through their deferred, contingent compensation structure, which they asserted is based heavily on performance of the securitized assets. Further, commenters stated that most CLO managers are registered investment advisors with associated fiduciary duties to their investors. One commenter also referred to other regulations and guidance, asserting that they already provide meaningful protections against imprudent or inferior underwriting, including the leveraged lending guidance released by the Federal banking agencies in 2013.[159] Several commenters also supported their arguments by indicating that the assets selected by CLO managers are evaluated through multiple layers of underwriting and market decisions and CLO loan portfolios are actively managed for much of the life of a CLO. Commenters further asserted that CLO managers select senior secured commercial loans with investor protection features. Some commenters asserted that, unlike many other securitizations, CLOs are securitizations of liquid assets and they are structurally transparent. They also stated that CLOs have historically performed well and that this strong performance is evidence that further regulation is unnecessary and that customary features of CLOs, including overcollateralization and interests coverage tests, protect investors. The alternative options and exemption requests are discussed in further detail below.

[159] *See Leveraged Lending Guidance.*

d. Response to Comments

i. Definition of ''Securitizer'' and Legislative History of Section 15G

The agencies have considered the concerns raised by commenters with respect to the reproposal, including with respect to open market CLOs. As discussed above, commenters asserted that CLO managers could not be ''securitizers'' within the definition thereof in section 15G of the Exchange Act, including the contention that they do not legally own, possess, or control the assets.

As explained in the reproposal, the agencies believe that CLO managers are clearly included within the statutory definition of ''securitizer'' set forth in section 15G of the Exchange Act. Subpart (a)(3)(B) of section 15G begins the definition of a ''securitizer'' by describing a securitizer as a ''person who organizes and initiates an asset-backed securities transaction.'' CLOs clearly meet the definition of ''asset-backed security'' set forth in section 3 of the Exchange Act, which defines ''asset-backed security'' as ''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 the cash flow from the asset.'' [160] As discussed above, a CLO is a fixed income or other security that is typically collateralized by portions of tranches of senior, secured commercial loans or similar obligations. The holder of a CLO is dependent upon the cash flow from the assets collateralizing the CLO in order to receive payments. Accordingly, a CLO is an asset-backed securities transaction for purposes of the risk retention rules.[161]

A CLO manager typically negotiates the primary deal terms of the transaction and the primary rights of the issuing entity and uniformly directs such entity to acquire the commercial loans that comprise its collateral pool. Under the plain language of the statute, therefore, a CLO manager organizes and initiates an asset-backed securities transaction.[162]

The definition continues that the organizer and initiator of a CLO does so

[160] *See* 15 U.S.C. 78c(a)(79).

[161] Furthermore, CDOs are specifically mentioned as examples both in the definition of ''asset-backed security'' and elsewhere in section 941 of the Dodd-Frank Act. *See* 15 U.S.C. 78c(a)(79)(A)(ii) and 78o–11(c)(1)(F). As discussed above, CLOs are a type of CDO and CLOs and CDOs have the same general structure.

[162] The definition of ''sponsor'' is discussed in Part II of this Supplementary Information.

''by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.'' A CLO manager indirectly transfers the assets to the CLO issuing entity because the CLO manager has sole authority to select the commercial loans to be purchased by the CLO issuing entity for inclusion in the CLO collateral pool, directs the issuing entity to purchase such assets in accordance with investment guidelines, and manages the securitized assets once deposited in the CLO structure. Most importantly, an asset is not transferred to the CLO issuing entity unless the CLO manager has selected the asset for inclusion in the CLO collateral pool and instructed the CLO issuing entity to acquire it.

Although some commenters have narrowly interpreted the term ''transferring'' to specifically require legal ownership or possession of the object being transferred, the agencies observe that the plain meaning of ''transfer'' does not first require ownership or possession and otherwise is not as narrow as these commenters assert.[163] ''Transfer'' is commonly defined as ''to cause to pass from one to another,'' which is precisely what the CLO manager does.[164] The CLO manager causes assets to be passed from the seller to the issuing entity because the CLO manager selects the assets for the collateral pool and directs the issuing entity to purchase such assets. Therefore, the CLO manager ''transfers'' the assets according to a commonly accepted definition of the word. There is no indication in the statute that Congress intended to interpret the word ''transfer'' as narrowly as commenters have advocated. If Congress had desired such an interpretation that would be narrower than how the term is commonly defined, the agencies believe that additional limiting language would have been included in the statute. CLO managers, therefore, fall clearly within the statutory definition of ''securitizer'' as set forth in Exchange Act section 15G.

Even if there were ambiguity as to whether CLO managers are covered by the definition of ''securitizer,'' the agencies believe that the interpretation of ''securitizer'' to include CLO managers is reasonable. In addition to being consistent with commonly used definitions of ''transfer,'' as discussed above, the interpretation is consistent with the context, purposes and legislative history of the statute. Further, the alternative interpretation argued by commenters would lead to results that would be contrary to the purposes of section 941 and Congressional intent.

The text surrounding the word ''transfer'' supports the agencies' interpretation of the word. To read ''transfer'' narrowly to require ownership or possession would make the preceding word ''sell'' superfluous because the act of selling necessarily involves the legal transfer of the asset.[165] In addition, the agencies do not believe that the phrase ''including through an affiliate'' bolsters the commenters' claim that ''transfer'' was intended to be interpreted in this limited manner because the use of the word ''include'' in a statute can signal that what follows is meant to be illustrative rather than exclusive.[166] As stated earlier, the agencies believe that 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 deposited in the CLO structure, which the agencies believe is a transfer or indirect transfer of the assets.

The agencies also disagree with the commenters' assertion that the CLO manager does not transfer or sell assets because, as an agent of the CLO, it is on the same side of the transaction as the purchaser (the special purpose issuing entity). Under the same reasoning, one could claim that an originator of assets that creates a special purpose vehicle to issue asset-backed securities and transfers assets to that special purpose vehicle could never be a securitizer, because the originator also essentially would be transferring the assets to itself. If that were the case, then many types of securitizations would not have an entity that would be subject to risk retention.

Moreover, the agencies disagree with commenters' assertions that Congress intended section 15G to apply primarily to securitizations within the originate-to-distribute model. Congress did not specify that the requirements of the statute apply only to certain types of securitization models or structures. Indeed, section 15G specifies that risk retention applies to all securitizers,[167] unless they have a specific exemption under the statute or the agencies provide a specific exemption in accordance with criteria set forth in the statutory text.[168] Congress did not specifically exclude securitizations that are not part of an originate-to-distribute model—or any other particular market model or structure of securitization—from risk retention. Although the legislative history indicates that Congress was concerned about securitizations within the originate-to-distribute model, nowhere in the text or legislative history did Congress indicate that it intended for risk retention not to apply to transactions that some may assert are not ''originate-to-distribute'' securitizations.

Furthermore, the leveraged loan market shares characteristics with the ''originate-to-distribute'' model that led to the deterioration in underwriting standards that were a major factor in the recent financial crisis. Originators of leveraged loans often retain little or no interest in the assets they originate, and originate and underwrite with the intention of distributing the entire loan. In this regard, leveraged loans purchased by CLOs are often originated as a fee-generating, rather than a lending business, and originators do not have the same incentive to underwrite carefully as they would for loans they intend to keep in portfolio. These characteristics of the leveraged loan market pose potential systemic risks similar to those observed in the residential mortgage market during the crisis, whether the loans are placed with CLOs or other types of institutional investors.

Additionally, there is no evidence to support the notion that Congress expected ''securitizer'' to be read narrowly so that risk retention requirements would apply only to sponsors of securitizations which have a specific type of structure or only to sponsors that fulfill a narrow and specific structural role in a

[163] *See, e.g., Babbitt* v. *Sweet Home Chapter of Communities for a Great Or.,* 515 U.S. 687, 697–98 (1995) (rejecting the argument that the word ''harm,'' defined ''to cause hurt or damage to: injure,'' should be read so narrowly as to require a showing of direct injury to something).

[164] *Merriam-Webster's Collegiate Dictionary* 1253 (10th ed. 1995); *See also Random House Webster's College Dictionary* 1366 (2nd ed. 1997); *The New Oxford American Dictionary* 1797 (Elizabeth J. Jewell & Frank Abate eds., 2001).

[165] *Cf. Hibbs* v. *Winn,* 542 U.S. 88, 101 (2004) (stating that it is one of the most basic interpretive canons, that '' '[a] statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant. . . .' '') (quoting 2A N. Singer, Statutes and Statutory Construction § 46.06, pp.181–186 (rev. 6th ed. 2000)).

[166] *See Samantar* v. *Yousuf,* 560 U.S. 305, 316–17 (2010). While Congress referred to transferring through affiliates as an example of indirect transfer, it did not preclude other forms of indirect transfer in the definition of ''securitizer,'' nor did it specifically limit the definition to parties in the chain of title.

[167] *See* 15 U.S.C. 78o–11(b)(1) (''[T]he Federal banking agencies and the Commission shall jointly prescribe regulations to require any securitizer to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party.'').

[168] *See* 15 U.S.C. 78o–11(c)(1)(G)(i) and 15 U.S.C. 78o–11(e).

securitization transaction. Furthermore, the agencies believe that the narrow reading of ''securitizer'' supported by commenters could lead to results that would appear contrary to Congressional intent by opening the statute to easy evasion. Under such an interpretation, it would be feasible for many sponsors to evade risk retention by hiring a third-party manager to ''select'' assets for purchase by the issuing entity that have been pre-approved by the sponsor. This could result in a situation in which no party to a securitization can be found to be a ''securitizer'' because the party that organizes the transaction and has the most influence over the quality of the securitized assets could avoid legally owning or possessing the assets.[169] Interpreting the term ''securitizer'' to produce such an easily evaded rule would be an unreasonable result that cannot comport with the intent of Congress in enacting section 15G of the Exchange Act.

With respect to the issuance of asset-backed securities, there is always a sponsor responsible for the organization and initiation of the issuance of asset-backed securities.[170] The issuing entity for a CLO transaction is a special purpose vehicle formed by some other party solely for the express purpose of issuing asset-backed securities. However, some person or other entity—namely, the sponsor—''organized and initiated'' this special purpose vehicle with the intent that this special purpose vehicle would issue asset-backed securities. The agencies do not believe that the special purpose vehicle formed to issue asset-backed securities in a CLO transaction does so independent of the actions of a sponsor. The agencies also note that the commenters did not identify another party to an open market CLO transaction other than the CLO manager that should be considered the sponsor.

As indicated in the legislative history of the Dodd-Frank Act, the broad purpose of the statute was to ''create incentives that will prevent a recurrence of the excesses and abuses that preceded the crisis, restore investor confidence in asset-backed finance, and permit securitization markets to resume their important role as sources of credit for households and businesses.'' [171] In drafting section 941, Congress recognized that it would be impractical for many investors to adequately assess and monitor the risks of assets underlying complex securitization products.[172] As a result, Congress sought to encourage monitoring and assessment of such assets by the parties better suited to do so, namely those who organize and initiate the securitizations.[173] Like other securitization sponsors, a CLO manager is the party best positioned to adequately monitor and assess the risk of the securitized assets. For the reasons discussed above, the agencies continue to find that a CLO manager is a ''securitizer'' under section 15G of the Exchange Act.[174]

ii. Exemption Requests and Alternative Proposals

Many commenters suggested that the risk retention rules should not be applied to open market CLOs because, as described above, they believe the structural and other characteristics of open market CLOs make risk retention unnecessary. Among the primary characteristics highlighted to justify an exemption, commenters asserted that CLO managers' subordinated compensation structure aligns their interests with those of investors, CLOs differ from the originate-to-distribute model, and the underwriting of CLOs' assets is subject to multiple levels of scrutiny. As an alternative to an exemption based solely on such characteristics, several commenters supported exemptions for open market CLOs meeting certain qualifications. One commenter proposed an exemption from risk retention for open market CLOs that met the following conditions: (i) The asset manager must be a registered investment adviser under the Investment Advisers Act of 1940;[175] (ii) all U.S. investors must be qualified purchasers or knowledgeable employees, consistent with reliance on the section 3(c)(7) exemption from investment company status under the Investment Company Act; [176] (iii) the pool of assets are permitted and expected to be traded by the asset manager on behalf of the issuer in accordance with contractually agreed restrictions; (iv) the asset management agreement establishes a standard of care that requires the asset manager to employ a degree of skill and care no less than it uses for its own investments and consistent with industry standards for asset managers that are acting on behalf of comparable clients; and (v) the investment adviser effects agency cross trades on behalf of its advisory client only in accordance with section 275.206(3)–2 of the Commission's rules under the Investment Advisers Act.[177]

The agencies also received several comments in continued support of an option that was suggested with respect to the original proposal that the agencies did not include in the revised proposal. This suggestion would allow an open market CLO manager to satisfy its risk retention requirement by holding a combination of notes issued by the CLO, modeled to reflect the risks assumed by CLO managers through their subordinated compensation structure, and equity securities issued by the CLO and purchased by the CLO manager.

Several commenters supported an option that would expand the above proposal by allowing managers of ''Qualified CLOs'' to satisfy the risk retention requirement by purchasing 5 percent of the CLO's equity and maintaining a subordinated compensation structure. Commenters proposed that, in order to be deemed a Qualified CLO, the CLO's governing transaction documents would have to include specific requirements in the following areas: Asset quality; portfolio composition; structural features; alignment of the interests of the CLO manager and investors in the CLO's securities; regulatory oversight; and transparency and disclosure. Commenters suggested requirements under each of these categories that they asserted would ensure high quality underwriting and investor protection. They also suggested that this proposal should be adopted along with the third-party option and pro rata risk retention reduction proposals described below, as they do not feel that the option alone would sufficiently address the projected

[169] As discussed, Congress clearly expected this rule to apply to sponsors of CDOs, but the commenters' claims, if credited, would also exclude sponsors of CDOs from the requirements of risk retention.

[170] Similar to the agencies interpretation of ''securitizer'' to include CLO managers, the definitions of ''issuer'' in both the Securities Exchange Act of 1934 and Securities Act of 1933 include, with respect to certain kinds of vehicles, ''the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which the securities are issued.''

[171] S. Rep. No. 111–176, at 128.

[172] *Id.*

[173] *Id.* at 129 (''When securitizers retain . . . risk, they have 'skin in the game,' aligning their economic interests with those of investors. . . . Securitizers who retain risk have a strong incentive to monitor the quality of the assets they purchase from originators, package into securities, and sell. . . . Originators . . . will come under increasing market discipline because securitizers who retain risk will be unwilling to purchase poor-quality assets.'').

[174] Furthermore, the agencies believe that this applies to other issuances of asset-backed securities in which the securitized assets are selected by a manager and no other transaction party meets the definition of ''sponsor.'' See Parts III.B.4 and III.B.8 of this Supplementary Information.

[175] 15 U.S.C. 80b–3(b).

[176] 15 U.S.C. 80a–3(c)(7).

[177] 17 CFR 275.206(3)–2.

effects that the rule will have on open market CLOs.

Several commenters suggested that the agencies could adopt the commenters' exemption proposals under the agencies' exemptive authority provided by section 15G(e).[178] Alternatively, commenters supporting the Qualified CLO proposal suggested the proposal could be adopted as a construction of the statutory requirement that a securitizer retain not less than 5 percent of the ''credit risk'' of any asset. In this regard, the commenters asserted that by acquiring 5 percent of the equity interest in the CLO, and by bearing the subordinated risk of non-payment embedded in the compensation structure demanded by investors, the CLO manager would be retaining far more than 5 percent of the credit risk associated with the CLO's assets. As support for this suggestion, the commenters cited research concluding that the majority of likely losses for a typical CLO are borne by the bottom 20 percent of the CLO capital structure.

The agencies do not believe that it would be appropriate to exempt open market CLOs from the risk retention requirement under section 15G(e). The statute permits the agencies to adopt or issue exemptions, if the exemption would: (A) help ensure high quality underwriting standards for the securitizers and originators of assets that are securitized or available for securitization; and (B) encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of consumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors.[179] While the agencies recognize that certain structural features of CLOs contribute to aligning the interests of CLO managers with investors, the agencies do not believe these structural features would support a finding that the exemption would help ensure high quality underwriting standards and there are reasons why such an exemption may run counter to the public interest and protection of investors.[180]

As discussed above, many of the structural features that commenters cited as mitigating risk factors for CLOs were shared by other types of CDOs, such as CDOs of asset-backed securities, that performed poorly during the financial crisis. Although the structural features can offer protection to investors in senior tranches, such protections are exhausted when a portfolio's default rate significantly exceeds anticipated losses, as was the case for CDOs of asset-backed securities during the financial crisis. In such a situation, the manager may be incented to engage in even more risky behavior to maintain cash flow and ensure the payment of its subordinated compensation. Although CLOs performed better than other CDOs during the financial crisis, the better performance of leveraged loans after the financial crisis in CLO portfolios could be partially attributed to lowered interest rates and other government interventions. Some commenters claimed that CLOs are composed of higher quality assets that undergo significant underwriting scrutiny and that include investor protection features, but the significant recent credit deterioration in the leveraged loan market, as described above, demonstrates increasing risks in the types of assets held by CLOs. The agencies also note that while the final rule does not include an exemption for open market CLOs, the removal of the proposed restriction on cash flow distributions to the eligible horizontal residual interest, as described in Part B.1 of this Supplementary Information, will provide greater flexibility for CLO managers to satisfy the standard risk retention option, which may reduce the cost of the standard risk retention option.

The agencies recognize that management fees incorporate credit risk sensitivity and may contribute to some degree to aligning the interests of the CLO manager and investors with respect to the quality of the securitized loans. On the other hand, as discussed above, this subordinated compensation structure could also lead to a misalignment of interests between the CLO manager and investors in certain circumstances. Moreover, as discussed in the reproposal, these fees do not appear to provide an adequate substitute for risk retention because they typically have small expected value, especially given that CLOs securitize leveraged loans, which carry higher risk than many other securitized assets. Even combining the expected value of the manager's compensation with a 5 percent interest in the equity of the CLO would be inadequate because, as described by a commenter, such an equity interest would also likely amount to under one percent of the fair value of the ABS interests issued to third parties (which is less than the 5 percent required for an eligible horizontal residual interest). Further, management fees are not funded in cash at closing and therefore may not be available to absorb losses as expected. Generally, the agencies have declined to recognize such unfunded forms of risk retention and the agencies are not persuaded that an exception should be made for open market CLOs.

Some commenters supported an alternative approach that would reduce the risk retention requirement for open market CLOs, on a pro rata basis, to the extent that the commercial loans backing the issued CLO securities met certain underwriting criteria. In order to qualify for reduced risk retention, the commercial loans would have to be senior secured first lien loans that either (i) have a ratio of first lien debt to total capitalization of less than or equal to 50 percent; or (ii) have a total leverage ratio of less than or equal to 4.5 times.[181] Further, this approach would reduce the risk retention requirement to the extent that the CLO holds a subset of loans requiring certain specialized treatment. This approach would require determination of whether a loan qualifies for reduced risk retention treatment to be made at the time of origination. Further, this approach provided that loans originated before the applicable effective date of the rule should not require risk retention when securitized after such date.

The agencies are not persuaded that the risk retention requirement should be reduced to the extent commercial loans backing the issued CLO securities meet the criteria proposed by the commenters. As discussed in Part V.A of this Supplementary Information, the final rule already provides exemptions from the risk retention requirement for qualifying commercial loans that meet specific underwriting standards. The agencies developed these standards to be reflective of very high quality loans. The commenters' approach relies on significantly weaker standards, and the agencies do not believe that these criteria, which would permit securitization with no risk retention for loans to borrowers who are of lower credit quality or that do not have a third-party evaluation of the likelihood of timely payment of interest and repayment of principal, would satisfy the statutory requirements for an exception to help ensure high quality underwriting standards.

[178] One commenter suggested that the Qualified CLO proposal could also be exempted based on the agencies' authority under section 15G(c)(1)(G)(i).

[179] 15 U.S.C. 78o–11(e)(2).

[180] For similar reasons, the agencies do not believe an exemption would be appropriate under section 15G(c)(1)(G)(i).

[181] In this context, leverage ratio refers to the borrower's total debt divided by earnings before interest, taxes, depreciation and amortization (EBITDA).

The agencies also disagree with the proposition that, in the context of CLOs, loans originated before the applicable effective date of the rule should not be subject to risk retention. Section 15G of the Exchange Act applies to any issuance of asset-backed securities after the applicable effective date of the rule, regardless of the date the assets in the securitization were originated. The agencies note, however, that securitizations of loans meeting the seasoned loan exemption in section 19(b)(7) of the rule would not be subject to risk retention requirements.

The agencies also received a number of comments in support of approaches to allow a third party, rather than the CLO manager, to retain some or all of the required credit risk in certain circumstances. To be eligible under these approaches, the third party would be required to have a role in setting the selection criteria for the assets held by a CLO and the power to veto any change to asset selection criteria. Specifically, the commenters' proposal would require: (i) Prior to the CLO's acquisition of the initial CLO assets, the third party to review and assent to key transaction portfolio terms, including the asset eligibility criteria, concentration limits, collateral quality tests, and reinvestment criteria of the CLO's asset pool; and (ii) any material change to the above parameters to receive prior written consent by the third party retaining the CLO credit risk. Further, to enable the third party retaining credit risk to evaluate, before the CLO closes, whether the CLO manager is able to meet the asset selection criteria, the commenters proposed that at least 50 percent of the initial asset pool would have to be acquired (or be under a commitment to be acquired) by the closing date. One of the approaches would also require that the CLO manager be a registered investment adviser and would permit multiple parties to jointly satisfy the CLO's risk retention requirement.

Another commenter proposed a different third-party retention option, under which a sponsor's risk retention requirement would be satisfied if one or more third parties agreed to hold the required minimum risk retention. The commenter's suggested option would only apply to CLOs that are securitizations of corporate debt and servicing assets; inclusion of other ABS interests would be prohibited. The third party or a party appointed by the third party would be required to perform an independent review of the credit risk of each securitized asset. Further, the proposal would require the CLO manager to provide information to investors about the investment experience of each third-party purchaser.

While the agencies considered the third-party retention proposals carefully, they have concluded that the proposals would not provide an appropriate method of risk retention. The proposed third-party retention options would result in retention of the credit risk by a third party that would have less control over the CLO portfolio than the CLO manager. These alternatives would result in weaker means of influencing the underwriting quality in CLO portfolios and are therefore inadequate substitutes for risk retention.

While, as discussed in Part III.B.5 of this Supplementary Information, the final rule allows third-party purchasers to retain credit risk in CMBS transactions, CLO and CMBS transactions vary in several significant ways that make such an option more challenging in the CLO context. For example, differences between CMBS and CLO transactions would make it more challenging for third-party investors to perform thorough independent reviews of loans in CLO portfolios, including the dynamic nature of CLO portfolios and the larger number of loans in typical CLO portfolios. In CMBS transactions, the loan pool is chosen and is static before issuance, which permits loan-level due diligence by the third-party investor. In CLOs, the loan pool is typically not complete before issuance, and the pool is dynamic, limiting the ability of a third-party investor to conduct loan-level due diligence before issuance. Under proposals submitted by commenters, the third-party purchaser would be limited to evaluating investment criteria for the CLO and would not conduct loan-level due diligence. In this regard, the third-party purchaser would not be conducting loan-level re-underwriting, and consequently is not a reasonable substitute for the original effort of the sponsor in underwriting the loan pool. Furthermore, the third-party retention proposals would provide the third-party purchaser with minimal power or influence over the composition or quality of the CLO's collateral pool after closing. In contrast to CMBS transactions that generally give the third-party purchaser the right to reject loans from the pool, no similar authority would be granted to CLO third-party purchasers under commenters' proposals.

Given the weakening of underwriting and increase in risk in the leveraged loan market, the agencies do not believe that existing market practice is sufficiently robust to substitute for risk retention. Furthermore, the agencies do not believe the alternative approaches suggested by commenters would significantly add protection to investors, as investors in CLOs would presumably already have the opportunity to review and assent to key portfolio transaction terms.[182] For these reasons, the agencies have decided against adopting the third-party risk retention option. While the agencies considered whether further parameters around a third-party risk retention option for CLO sponsors would be appropriate, the agencies were not able to identify parameters that would function well for CLOs or that would further the regulatory purposes of the risk retention rules.

The agencies have also carefully considered commenters' views about the impact the proposed rules would have on CLO issuance and the commercial loan markets in general. As discussed in the reproposal, the agencies acknowledge that requiring open market CLO managers to satisfy the risk retention requirement could result in fewer CLO issuances and less competition in this market. However, the agencies note that other entities, such as hedge funds and loan mutual funds, also purchase commercial loans and believe that the market will adjust to the rule and that lending to creditworthy commercial borrowers, on appropriate terms, will continue at a healthy rate. The agencies also note that commenters' concerns about the impact of European risk retention requirements on European CLO issuance may be misplaced, as economic conditions have constrained the available supply of potential collateral for European CLOs.

Furthermore, the agencies believe projected impacts on the CLO market are justified by the benefits that will be produced by subjecting open market CLOs to the risk retention rules. As discussed, the agencies have significant concerns about recent activity in the leveraged loan market. The search for yield in the low interest rate environment has led investors to take on more risk in this market by investing in lower quality commercial loans that contain fewer lender protections.[183] The agencies believe that valuations on lower-rated corporate bonds and

[182] The risk retention approaches for CLOs suggested by commenters also reflect standard market practices for certain other types of CDOs (*e.g.,* CDOs of asset-backed securities) that performed poorly during the financial crisis in which key investors negotiated asset selection criteria and reinvestment criteria and changes to those criteria required investor consent.

[183] *See, e.g., Monetary Policy Report,* at 1–2, 22; *Semiannual Risk Perspective: Spring 2014,* at 5.

leveraged loans are stretched and excesses in these markets could lead to higher levels of future defaults and losses.[184] The origination and securitization of such poorly underwritten loans could generate systemic financial risks.[185]

Increased appetite from investors for higher yielding and higher risk assets in the leveraged loan market creates an environment susceptible to some of the abuses and excesses that occurred in the residential and commercial mortgage markets that contributed to the financial crisis. In particular, the agencies are concerned that this environment could create incentives to originate an increased volume of loans, without regard for quality or underwriting standards, for the purpose of distribution through securitization. The agencies therefore have concluded that requiring open market CLO managers or lead arrangers to retain economic exposure in the securitized assets will help ensure the quality of assets purchased by CLOs, promote discipline in the underwriting standards for such loans, and reduce the risk that such loans pose to financial stability.

For the reasons discussed above, the final rule requires open market CLO managers to satisfy the minimum risk retention requirement for each CLO securitization transaction that it manages by holding a sufficient amount of standard risk retention or meet the requirements of the alternative lead arranger option. After considering all comments, the agencies are adopting, largely as proposed, the lead arranger option for open market CLOs, under which an open market CLO could satisfy the risk retention requirement if the firm serving as lead arranger for each loan purchased by the CLO retains at the origination of the syndicated loan at least 5 percent of the face amount of the term loan tranche purchased by the CLO. The lead arranger is required to retain this portion of the loan tranche until the repayment, maturity, involuntary and unscheduled acceleration, payment default, or bankruptcy default of the loan. This requirement applies regardless of whether the loan tranche was purchased on the primary or secondary market, or was held at any particular time by an open market CLO issuing entity.

Under the final rule's lead arranger option, the sponsor is required to disclose a complete list of every asset held by an open market CLO (or before the CLO's closing, in a warehouse facility in anticipation of transfer into the CLO at closing). This list requires the following information (i) the full legal name, Standard Industrial Classification category code and legal entity identifier (LEI) issued by a utility endorsed or otherwise governed by the Global LEI Regulatory Oversight Committee or the Global LEI Foundation (if an LEI has been obtained by the obligor) of the obligor of the loan or asset; (ii) the full name of the specific CLO-eligible loan tranche held by the CLO; (iii) the face amount of the CLO-eligible loan tranche held by the CLO; (iv) the price at which the CLO-eligible loan tranche was acquired by the CLO; and (v) for each loan tranche, the full legal name of the lead arranger subject to the sales and hedging restrictions. Also, the final rule requires the sponsor to disclose the full legal name and form of organization of the CLO manager. The sponsor is required to provide these disclosures a reasonable period of time prior to the sale of the asset-backed securities in the securitization transaction (and at least annually with respect to information regarding the assets held by the CLO) and, upon request, to the Commission and the sponsor's appropriate Federal banking agency, if any. Further, the CLO manager is required to certify or represent as to the adequacy of the collateral and certain attributes of the borrowers of the senior, secured syndicated loans acquired by the CLO and certain other matters.

The agencies have added to the disclosure requirement the disclosure of an obligor's LEI issued by a utility endorsed or otherwise governed by the Global LEI Regulatory Oversight Committee or the Global LEI Foundation, if an LEI has been obtained by the obligor. The agencies believe that the LEI requirement allows investors in open-market CLOs to better track the performance of assets originated by specific originators. The effort to standardize a universal LEI has progressed significantly over the last few years.[186] As LEI use becomes more mandated and widespread pursuant to other rules, the agencies anticipate that LEI disclosure by obligors under the lead arranger option will become the standard.

In response to commenter concerns, the agencies have removed from the lead arranger option for open market CLOs the requirement that lead arrangers and CLO managers certify as to the adequacy of the collateral and the attributes of the borrowers of the senior, secured syndicated loans that they purchase and certain other matters and make certain covenants. Instead, a lead arranger will be required to certify that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that loans included in a CLO-eligible tranche meet all of the requirements set forth in section 9 of the rule applicable to CLO-eligible loan tranches and has concluded that its internal supervisory controls are effective. CLO managers will be required to certify that they have policies and procedures to evaluate the likelihood of repayment and that they have followed such policies and procedures when determining the adequacy of the collateral and attributes of the borrowers of the loans that they purchase. These certifications are similar to those required of depositors with respect to QRMs and other qualifying asset classes. The agencies believe these modifications will reduce concerns about risks and challenges that commenters asserted would be faced in connection with the requirement that there be representations that the loans meet the rule's criteria. The agencies also note that the reference to ''ensuring'' that loans are CLO-eligible loans should be interpreted in a manner similar to such reference in this Supplementary Information with respect to QRMs and other qualifying asset classes.

As the agencies noted in the reproposal, the lead arranger option for open market CLOs is intended to allocate risk retention to the parties that originate the underlying loans and that likely exert the greatest influence on how the loans are underwritten, which is an integral component of ensuring the quality of assets that are securitized. Subject to considering certain factors, section 15G permits the agencies to allow an originator (rather than a sponsor) to retain the required amount of credit risk and to reduce the amount of credit risk required of the sponsor by the amount retained by the originator.[187] In developing the

[184] *See, e.g., Monetary Policy Report,* at 1–2.

[185] *See, e.g.,* Leveraged Lending Guidance at 17771 (''[A] poorly underwritten leveraged loan that is pooled with other loans or is participated with other institutions may generate risk for the financial system.''); *Shared National Credits Program: 2013 Review* at 8 (''Poorly underwritten or low quality leveraged loans, including those that are pooled with other loans or participated with other institutions, may generate risks for the financial system.'').

[186] The Commission has prescribed the disclosure of LEI in other rulemakings. *See, e. g.,* Nationally Recognized Statistical Rating Organizations; Final Rule, 79 FR 55078 (Sept. 15, 2014) and Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF; Final Rule, 76 FR 71128 (Nov. 16, 2011).

[187] 15 U.S.C. 78o–11(c)(G)(iv), (d) (permitting the Commission and Federal banking agencies to allow

proposed lead arranger option, the agencies considered the factors set forth in section 15G(d)(2) and concluded that it is consistent with the purposes of the statute to allow lead arrangers of open market CLOs to satisfy the risk retention requirement.[188]

The agencies considered the commenters' views that the option will not be widely adopted by lead arranger banks, but the agencies believe the option provides additional flexibility for lead arranger banks and non-banks and therefore may reduce disruption to the market. The agencies also believe that this option for open market CLOs will meaningfully align the incentives of the party most involved with the credit quality of these loans—the lead arranger—with the interests of investors. Commenters raised concerns that banks would likely not want to retain risk without being allowed to hedge or transfer that risk due to concern about criticism from regulators. However, the agencies note that these concerns were not raised for balance sheet CLOs where banks would be required similarly to retain a portion of the loans' risk without selling or transferring that retained risk. In addition, to the extent the comments referred to supervisory standards, the Federal banking agencies note that supervisors take into account many considerations when reviewing loan portfolios, including applicable regulations and guidance regarding underwriting and risk management. Alternatively, incentives would be placed on the CLO manager to monitor the credit quality of loans it securitizes, if it retains risk under the standard risk retention option.

For the reasons discussed above, open market CLO managers clearly fall within the statutory definition of ''securitizer'' in Section 15G and therefore are subject to the risk retention requirement. The agencies also believe that subjecting open market CLOs and their managers to the risk retention requirement is within their authority and consistent with the purposes of section 15G. The agencies believe the final rule places risk retention responsibility on the parties most capable of ensuring and monitoring the credit quality of the assets collateralizing open market CLOs—the CLO manager or the lead arranger. Further, the agencies believe these two options provide sufficient flexibility to avoid significant disruptions to the CLO and credit markets.

8. Municipal Bond ''Repackaging'' Securitizations

a. Overview of the Reproposal and Public Comments

Several commenters on the original proposal requested that the agencies exempt municipal bond repackaging securitizations from risk retention requirements, the most common form of which are often referred to as ''tender option bonds.'' [189] In order to reflect and incorporate the risk retention mechanisms currently implemented by the market, the reproposal included two additional risk retention options for certain municipal bond repackagings. The proposed rule closely tracked certain requirements for these repackagings, outlined in IRS Revenue Procedure 2003–84, that are relevant to risk retention.[190] Specifically, in the revised proposal, the agencies proposed additional risk retention options for municipal bond repackagings issued by a ''qualified tender option bond entity,'' which would be defined as an issuing entity of tender option bonds in which:

- Only two classes of securities are issued: a tender option bond and a residual interest;
- The tender option bond qualifies for purchase by money market funds under Rule 2a–7 under the Investment Company Act of 1940; [191]
- The holder of a tender option bond has the right to tender such bonds to the issuing entity for purchase at any time upon no more than 30 days' notice; [192]
- The collateral consists solely of municipal securities as defined in section 3(a)(29) of the Securities Exchange Act of 1934 and servicing assets, and all the municipal securities have the same municipal issuer and the same underlying obligor or source of payment;
- Each of the tender option bond, the residual interest and the underlying municipal security are issued in compliance with the Internal Revenue Code of 1986, as amended (the ''IRS Code''), such that the interest payments made on those securities are excludable from the gross income of the owners;
- The issuing entity has a legally binding commitment from a regulated liquidity provider to provide 100 percent guarantee or liquidity coverage with respect to all of the issuing entity's outstanding tender option bonds; [193] and
- The issuing entity qualifies for monthly closing elections pursuant to IRS Revenue Procedure 2003–84, as amended or supplemented from time to time.

Under the reproposal, the sponsor of a qualified tender option bond entity could satisfy its risk retention requirements by retaining an interest that, upon issuance, would meet 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, would meet requirements of an eligible vertical interest.[194]

the allocation of risk retention from a sponsor to an originator).

[188] 15 U.S.C. 78o–11(d)(2). These factors are whether the assets sold to the securitizer have terms, conditions, and characteristics that reflect low credit risk; whether the form or volume of transactions in securitization markets creates incentives for imprudent origination of the type of loan or asset to be sold to the securitizer; and the potential impact of risk retention obligations on the access of consumers and business to credit on reasonable terms, which may not include the transfer of credit risk to a third party.

[189] As described by one commenter, a typical tender option bond transaction 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: floating rate, puttable securities (the ''floaters''), and an inverse floating rate security (the ''residual''). The holders of floaters have the right, generally on a daily or weekly basis, to put the floaters for purchase at par, which put right is supported by a liquidity facility delivered by a highly rated provider and causes the floaters to be a short-term security. The floaters are in large part purchased and held by money market mutual funds. The residual is held by a longer term investor (bank, insurance company, mutual fund, hedge fund, etc.). The residual investor takes all of the market and structural risk related to the tender option bond structure, with the floaters investors only taking limited, well-defined insolvency and default risks associated with the underlying municipal bonds, which risks are equivalent to those associated with investing in such municipal bonds directly.

[190] Revenue Procedure 2003–84, 2003–48 I.R.B. 1159.

[191] This requirement is in section 10 of the final rule (definition of ''tender option bond'').

[192] This requirement is in section 10 of the final rule (definition of ''tender option bond'').

[193] The final rule defines a regulated liquidity provider as a depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)); a bank holding company (as defined in 12 U.S.C. 1841) or a subsidiary thereof; a savings and loan holding company (as defined in 12 U.S.C. 1467a) provided all or substantially all of the holding company's activities are permissible for a financial holding company under 12 U.S.C. 1843(k) or a subsidiary thereof; or a foreign bank (or a subsidiary thereof) whose home country supervisor (as defined in section 211.21 of the Board's Regulation K (12 CFR 211.21)) has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision, as amended, provided the foreign bank is subject to such standards.

[194] Section 4.01(5) of IRS Revenue Procedure 2003–84 defines a tender option termination event as: (1) a bankruptcy filing by or against a tax-exempt bond issuer; (2) a downgrade in the credit-rating of a tax-exempt bond and a downgrade in the credit rating of any guarantor of the tax-exempt bond, if applicable, below investment grade; (3) a payment default on a tax-exempt bond; (4) a final judicial determination or a final IRS administrative determination of taxability of a tax-exempt bond for

Continued

Under the reproposal, the sponsor of a qualified tender option bond entity could also 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 would be equal to 5 percent of the face value of the municipal securities deposited in the qualified tender option bond entity.

The proposed prohibitions on transfer and hedging set forth in section 12 of the reproposal applied to the holder of a residual interest in, as well as any municipal securities retained by the sponsor of, a qualified tender option bond entity, if those interests were held in satisfaction of the sponsor's risk retention requirements under section 10 of the reproposal.

The reproposal also would have allowed the sponsor of a qualified tender option bond entity to satisfy its risk retention requirements under subpart B of the proposed rule using any other risk retention option in the reproposal, provided the sponsor meets the requirements of that option.

The agencies received many comments regarding the proposed tender option bond options. Most of the comments requested an exemption from risk retention for tender option bonds and, in the absence of an exemption, recommended either technical clarifications or adjustments to the proposed options for tender option bonds to cover a broader range of transaction structures.

Several commenters recommended that the final rule exclude issuance of tender option bonds from the risk retention requirements for a variety of reasons, including:

- The originate-to-distribute model that poses moral hazard risks in certain securitization transactions is not present in a tender option bond program;
- The tender option bond structure does not create information gaps for investors because tender option bond programs do not involve pooling large numbers of unrelated assets;
- The underlying bonds in a tender option bond structure generally are from one original issuance with the same issuer and borrower/obligor;
- The fund that selects the municipal bond to be deposited into a tender option bond structure retains virtually all of the risk related to such municipal bonds, and the tender option bond structure provides liquidity that is not found with typical asset-backed security products; and
- The industry generally does not define tender option bonds as structured finance products or asset-backed securities.

Commenters urging exclusion of tender option bonds from the risk retention requirements also stated that the current tender option bond market provides municipal issuers with access to a diverse investor base and a more liquid market, and subjecting tender option bonds to the risk retention requirements would significantly increase the costs of tender option bond programs and adversely affect the state and local governments that indirectly receive funding through these programs. They also commented that applying the risk retention rules to these structures would decrease the availability of tax-exempt investments in the market for money market funds, which are continuing to face limited investment options due to constraints imposed by Rule 2a–7 under the Investment Company Act.

A few commenters proposed that a sponsor of tender option bonds could satisfy its risk retention requirements if the residual interest holder provides, either directly or indirectly through an affiliate (i) 100 percent liquidity coverage on the floaters, (ii) a binding reimbursement obligation to the provider of the 100 percent liquidity coverage, or (iii) 100 percent credit enhancement on the underlying municipal securities. A few commenters took the position that any residual interest in any tender option bond structure should qualify as a risk retention option under the rule if the residual interest is held by an unaffiliated entity that agrees to subordinate its right to payment to the floater holders and the liquidity provider until the occurrence of a tender option termination event.

One commenter recommended broadening the exemption relating to asset-backed securities issued or guaranteed by a state or municipal entity to include securities collateralized by such exempt securities. Several commenters proposed that only municipal bond repackaging transactions with initial closing dates after the applicable effective date of the rule be subject to the risk retention requirements.

Other commenters advocated for a broader tender option bond risk retention option that would include most or all currently existing tender option bond programs, including those that issue tender option bonds with a notice period for tender of up to 397 days, tender option bond programs that hold assets other than tax-exempt municipal securities and servicing assets,[195] tender option bond programs that hold securities issued by more than one issuer,[196] and tender option bond programs in which the required retained interest is held by multiple beneficial owners, so long as all such owners are managed by a common regulated entity.[197]

Several commenters suggested technical clarifications, adjustments and corrections, including: The definition of qualified tender option bond entity should clarify the requirements with respect to the liquidity guarantee;[198] the requirement that tender option bonds be eligible securities under Rule 2a–7 under the Investment Company Act should be removed because it is unnecessary in the risk retention context; the definition of tender option bond should be revised so that the purchase price is par or face value plus accrued interest; the definition of qualified tender option bond entity should require that the tender right be supported by a liquidity facility or guarantee, except upon the occurrence of specified tender option termination events, and that such liquidity facility or guarantee be enforceable against the entity obligated to support or guarantee the purchase of the bonds upon tender; and the agencies should provide more specific guidance on how the disclosure

Federal default on the underlying municipal securities and credit enhancement, where applicable; (5) a credit rating downgrade below investment grade; (6) the bankruptcy of the issuer and, when applicable, the credit enhancer; or (7) the determination that the municipal securities are taxable.

[195] One commenter explained that other qualifying assets should include taxable municipal securities, preferred stock of registered closed-end investment companies that primarily invest in municipal securities, tender option bonds or tender option bond residual interests that are already issued and outstanding, and custodial receipts representing beneficial interests in any of the foregoing. A second commenter's alternative proposal includes tender option bond programs that hold taxable municipal securities and ''securities evidencing a beneficial ownership interest in municipal securities.'' A third commenter's alternative proposal included tender option bond programs for which the ''underlying collateral consists solely of tax-exempt assets or beneficial interests in such assets.''

[196] One commenter explained, in limited instances, assets held by tender option bond trusts consist of municipal securities from different issues from the same issuer or of more than one issuer.

[197] One commenter explained that this allocation is common practice in large fund complexes, and broadening this definition would not change the alignment of interests of the trust holders. Another commenter requested that the agencies allow multiple investment companies to satisfy the sponsor risk retention requirements.

[198] One commenter explained that the liquidity facility in a tender option bond program is typically structured as a credit enhancement of the underlying assets and not of the floaters themselves.

requirements would apply to tender option bonds.[199]

A few commenters expressed concern that the option to retain the residual interest only if it otherwise qualified as an eligible horizontal residual interest before, and an eligible vertical interest after, the occurrence of a tender option termination event was inconsistent with the partnership tax analysis used to pass through the tax-exempt interest on the bonds because the residual interest in a tender option bond structure is not legally subordinated at any time. However, another commenter stated that a residual interest is substantially equivalent to an eligible horizontal residual interest prior to the occurrence of a tender option termination event and an eligible vertical interest after a tender option termination event because (i) prior to the occurrence of a tender option termination event, the residual holder bears all the market risk, and (ii) after a tender option termination event, any credit losses are shared pro rata between the floaters and the residuals.

As part of a broader alternative definition for a qualified tender option bond entity, it was suggested that the retained risk in a qualified municipal repackaging entity should be either a residual or legally subordinate ABS interest equal to at least 5 percent of the face value (or fair market value, if no face value is available) of the assets of the entity at closing.

A group of commenters suggested that, if the agencies do not provide a full exemption for tender option bonds, the rule should state that retaining a residual interest in a qualified tender option bond entity equal to 5 percent of the fair value (determined as of the date of deposit) of the deposited assets should satisfy the risk retention requirements, without regard to the requirements applicable to eligible horizontal residual interest or eligible vertical interest requirements.

Other commenters recommended that the agencies permit the sponsor or the residual holder to purchase and retain a residual interest with an upfront cash investment value equal to 5 percent of the initial market value of the municipal securities in the tender option bond program. In addition, commenters asked that the rule allow a sponsor to aggregate the amount of a tender option bond residual interest it holds, with the municipal securities it directly holds, as of the date of deposit, in determining its risk retention requirement.

It was also suggested that the value of the collateral posted by a residual holder for a liquidity facility should be recognized, and that the residual holder's interest should be calculated as the sum of (a) the face amount of the residual certificate and (b) the market value of the collateral posted by the residual to secure the liquidity facility.

In terms of valuing the residual interest, one commenter suggested that the 5 percent market value retention amount be calculated at the time of the purchase of the municipal bond or the issuance of securities, to better conform to common industry practice and the realities of the tender option bond program, if the agencies decide not to exempt tender option bonds. This commenter explained that it would be impractical and costly to constantly monitor any fluctuation in the market value of the municipal bonds, and that no adjustments should have to be made if, during the life of the tender option bond trust, the market value of those bonds fluctuates above or below the market value that is initially calculated.

Several commenters requested that the agencies permit a party other than the sponsor of the issuing entity with respect to tender option bonds to be the risk retainer. Commenters stated that such a party may include a third-party investor that selects the underlying asset for the transaction and obtains the primary financing benefit of the structure, the funds or other investors that purchase residuals in the tender option bond trust to satisfy the sponsor's risk retention obligations as third-party purchasers, and a third-party investor with respect to tender option bond programs that are made available by sponsors and used by such third-party investors.

A few commenters requested that the final rule confirm that the ''sponsor'' is the bank that creates the tender option bond program. Commenters explained that the residual holders do not perform any of the traditional functions of a sponsor. One commenter claimed that deeming the funds that purchase residuals to be the ''sponsors'' for purposes of risk retention would have implications under other rules that use the term ''sponsor,'' including Rule 2a–7 under the Investment Company Act and proposed Securities Act Rule 127B.

In connection with the prohibition on hedging in the reproposal, which prohibits hedges that are ''materially related to the credit risk'' of the tender option bond residual interests and securitized assets, a group of commenters requested that the agencies clarify the meaning of that restriction to ensure that sponsors can manage the risks associated with up to 95 percent of the assets held by a tender option bond program. It was also requested that the agencies exclude from the hedging prohibition: (i) risk reducing and other transactions with regard to the underlying municipal security that are entered into by the sponsor prior to the establishment of the municipal bond repackaging structure, and (ii) transactions between the sponsor or its affiliates and an unrelated third party where the purpose of such transaction is to provide financing to such unrelated third party for such municipal securities on connection with a municipal bond repackaging structure.

b. Final Rule

After considering carefully the comments received on the reproposal as well as the purpose and language of section 15G of the Exchange Act, the agencies have adopted in the final rule the proposed tender option bond options with some modifications. In response to specific commenter concerns, the final rule incorporates certain technical clarifications and adjustments.

The final rule does not provide an exemption from risk retention requirements for sponsors of issuing entities with respect to tender option bonds. The agencies continue to believe that tender options bonds are asset-backed securities under the definition in section 15G because they are securities collateralized by self-liquidating financial assets and the holders of the securities receive payments that depend primarily on cash flow from the securitized assets.[200] Therefore, the sponsors of the issuing entities with respect to tender option bonds are subject to section 15G and the credit risk retention rules.

Consistent with the treatment of sponsors of other asset-backed securities, the holder of risk retention in connection with the issuance of tender option bonds may divide the ABS interests or tax-exempt municipal securities required to be retained under the final rule among its majority-owned affiliates, but may not do so among unrelated entities that are managed by the sponsor or managed by an affiliate of the sponsor. Accordingly, the sponsor of a tender option bond issuance under the rule may not sell the ABS interests

[199] One commenter asked that the agencies clarify that the disclosure requirements applicable to the sponsor of a qualified municipal repackaging entity be limited to: (i) the name and form of organization of the qualified municipal repackaging entity, (ii) a description of the form and material terms of the retained interest, (iii) whether the qualified municipal residual interest is held by the sponsor or a qualified residual holder, and (iv) a description of the face value or fair value of the qualified municipal residual interest or the municipal securities that are separately retained.

[200] 15 U.S.C. 78o–11(a).

required to be retained under the rule to a fund it manages unless such fund is a majority-owned affiliate of the sponsor. Otherwise, the credit risk associated with holding the ABS interest will be transferred to the investors in the fund that purchased those ABS interests, which would undermine the purpose and intent of the statute.

The agencies believe that, with respect to some issuances of asset-backed securities, it is possible that more than one party could meet the definition of sponsor in the rule.[201] With respect to those issuances, it is the responsibility of the transaction parties to designate which party is the sponsor and that party is then subject to the requirements of the risk retention rules.[202] The agencies note that various commenters requested that the agencies designate the bank that arranges and organizes the issuance of tender option bonds or the party that owns the residual interest as the sponsor. Regarding such requests, the agencies note that the party required to comply with the risk retention rules with respect to a tender option bond issuance is the party or parties that meet the definition of ''sponsor'' in the rule[203] and, depending on the specific facts and circumstances of the issuance and how the parties structure the transaction, either the arranging bank or the residual holder could be designated as the sponsor in accordance with the final rule.[204]

The purpose of the tender option bond risk retention options was to address existing market practice for traditional tender option bond issuances that are specifically structured such that the interest payments made on those securities are excludable from the gross income of the owners in the same way that the interest on the underlying municipal securities is excludable. Certain commenters suggested that the requirement that a residual interest in a tender option bond structure meet the requirements of an eligible horizontal residual interest before, and an eligible vertical interest after, the occurrence of a tender option termination event was inconsistent with the partnership tax analysis required to be used to ensure the pass-through treatment of the tax-exempt interest on the tender option bonds and tender option bond residuals. The agencies acknowledge that some asset-backed securities are not legally structured as debt and, in order to address this, the reproposal included and the final rule adopts a definition of ''collateral'' which explicitly applies ''irrespective of the legal structure of issuance'' and includes ''fractional undivided property interests in the assets or other property of the issuing entity, or any other property interest in such assets or other property.'' The agencies believe that a residual interest in a qualified tender option bond entity would meet the requirements of an eligible horizontal residual interest before, and an eligible vertical interest after, the occurrence of a tender option termination event if: (i) prior to the occurrence of a tender option termination event, the residual holder bears all the market risk associated with the underlying tax-exempt municipal security; and (ii) after the occurrence of a tender option termination event, any credit losses are shared pro rata between the tender option bonds and the residual interest.

The agencies do not agree with comments suggesting that tender option bond structures with an initial closing date prior to the date on which rule becomes effective should be exempt from the rule or ''grandfathered.'' Consistent with the statute, the agencies believe that the sponsor of issuances of asset-backed securities after the applicable effective date should be subject to risk retention requirements regardless of when the structure that issues those securities was formed. A tender option bond structure may issue additional asset-backed securities on multiple dates and may often substitute collateral. These features, and the broad exemptive relief requested by commenters, would allow for potentially limitless issuances of asset-backed securities which would not be subject to any risk retention requirements. Requiring tender option bond structures to meet the credit risk retention requirements regardless of their closing date is consistent with treatment of other securitization structures that exist prior to and continue to issue ABS interests after the applicable effective date of the rule, such as ABCP conduits and revolving pool securitizations.

The agencies have determined not to revise the definition of qualified tender option bond entity to expand the types of assets such structures can hold.[205] The tender option bond option in section 10 of the final rule is narrowly drawn to address risk retention practices in existing market structures and limit potential for abuse that could result from a broad exemption based entirely on structural features. Accordingly, under the final rule, sponsors of issuances of asset-backed securities that are subject to risk retention and that are collateralized by assets other than tax-exempt municipal securities[206] with the same municipal issuer and the same underlying obligor or source of payment will need to comply with the requirements of one of the other credit risk retention options. As a result, the final rule does not permit a qualified tender option bond entity to hold a residual interest in another tender option bond program or preferred stock in a closed-end investment company that invests in municipal securities.

The agencies have adopted the definition of tender option bond with one change and a clarification. After considering comments, the agencies are permitting tender option bonds with a notice period of up to 397 days to qualify for the specialized option. The agencies note that this time frame corresponds to the maximum remaining

[201] The designation of a party as a sponsor of an issuance of asset-backed securities for purposes of the final rule is not related to whether or not such party is the sponsor for purposes of other rules and regulations, including for example Rule 2a–7 under the Investment Company Act (including the discussion of sponsor in the Money Market Fund Reform, 79 FR at 47876) or section 13G of the Bank Holding Company Act (Volcker Rule). Whether or not a party is the sponsor under a particular rule or regulation is determined by reference to that rule or regulation and the related legal authority.

[202] While this concern was specifically raised by commenters in the context of tender option bonds, the agencies note that it is possible that any issuance of asset-backed securities could have more than one party that meets the definition of sponsor, and the analysis in this section would apply regardless of the securitization structure or securitized assets.

[203] As noted in the discussion of the definition of ''securitizer'' with respect to CLOs in Part III.B.7 of this Supplementary Information, the agencies do not believe that a sponsor is required to have had legal ownership or possession of the assets that collateralize an issuance of asset-backed securities.

[204] Nothing in the final rule prohibits the use by a sponsor of agents in order to meet the sponsor's obligations under the final rule, including the use of third-party service providers, such as an underwriter or remarketing agent to distribute required disclosures to investors in a timely manner. However, the sponsor remains liable for compliance with its obligations under the final rule.

[205] As proposed, the final rule requires that the collateral for a qualified tender option bond entity to consist only of servicing assets and tax exempt municipal securities.

[206] The agencies believe that a beneficial interest in a tax-exempt municipal security may be held by a qualified tender option bond entity, but only if such beneficial interest is a pass-through and pro rata interest in the underlying tax-exempt municipal security. Therefore, a qualified tender option bond entity will be permitted to hold an asset-backed security collateralized by a tax-exempt municipal security only if such asset-backed security is a pass-through and pro rata interest in the underlying tax-exempt municipal security and the cash flows supporting such asset-backed security are not tranched. A qualified tender option bond entity will not be permitted to hold credit default swaps referencing municipal obligations or tranched asset-backed securities, such as tender option bonds.

maturity of securities allowed to be purchased by money market funds under Rule 2a–7 under the Investment Company Act. Consistent with the reproposal, the final rule requires that the tender option bond have features which entitle the holder to tender the bond for a purchase price equal to the approximate amortized cost of the security, plus accrued interest, if any. The agencies believe that, in the context of a tender option bond, ''amortized cost plus accrued interest'' typically equals face value or par value plus accrued interest.

In response to commenters' suggestions for valuation methodologies to determine the fair value of a residual interest in a tender option bond issuance, to the extent that a particular valuation methodology is appropriate in the fair value measurement framework under GAAP to determine the fair value of a residual interest in a tender option bond issuance, then such valuation methodology would be permitted under the final rule to determine the fair value of a retained residual interest in a tender option bond issuance. After careful consideration of commenters' suggestions for alternative valuation methodologies, the agencies do not believe there is a compelling reason to treat tender option bond residual interests differently from any other eligible horizontal residual interest, and the final rule requires that the sponsor of a tender option bond calculate the fair value of the residual interest.

Consistent with the reproposal, the final rule requires the amount of tax-exempt municipal securities held by the sponsor or a majority-owned affiliate of the sponsor outside of the qualified tender option bond entity to be determined by reference to the face value of the municipal securities deposited in the qualified tender option bond entity. For instance, if the face value of the tax-exempt municipal securities deposited into a qualified tender option bond entity is $100 million, the sponsor or a majority-owned affiliate of the sponsor will be required to hold tax-exempt municipal securities, identical to those deposited in the tender option bond entity with respect to legal maturity and coupon, with a face value of $5 million in order to satisfy its requirements under the final rule. The agencies continue to believe that this approach is an accurate and easily verifiable means of calculating 5 percent risk retention because the retained municipal securities are identical to and fungible with the deposited municipal securities. This approach should help to minimize operational costs, administrative burdens and additional costs.

Regarding commenters' requests that the agencies give a sponsor of a tender option bond credit for cash held as collateral for the liquidity agreement, the final rule does not allow such cash collateral credit to be credited toward satisfaction of the risk retention requirements unless the cash is held in an account that meets the requirements for an eligible horizontal cash reserve account. This result is consistent with the approach regarding cash reserves connected to issuances of asset-backed securities under other options in the final rule.

Regarding commenters' requests for certain adjustments to, and clarification of, the hedging prohibitions with respect to the tender option bond risk retention options and with respect to tender option bond issuances generally, the agencies believe there is no reason to treat sponsors of tender option bond structures any differently from sponsors of other asset-backed securities issuances. Therefore, subject to provisions of the rule regarding permitted hedges and the agencies' interpretation of the hedging restrictions discussed elsewhere in this preamble, the agencies believe that a hedging transaction entered into prior to the establishment of the tender option bond trust should be subject to the hedging prohibition. Permitting such hedges would allow the sponsor of a tender option bond issuance to hedge its credit risk exposure to the tender option bond issuance simply by hedging its expected exposure to the underlying assets prior to the initial issuance of the tender option bonds, effectively eliminating the hedging prohibition. Similarly, regarding commenters' requests for an exclusion for hedging transactions entered into between the sponsor of a tender option bond issuance or its affiliates and an unrelated party where the purpose of such transaction is to provide financing to such third party for the municipal securities to be deposited into a tender option bond structure, the agencies believe that the holder of retained credit risk should not be permitted to hedge its exposure to the retained credit risk. This approach is consistent with the treatment of all other credit risk retention options in the final rule. The agencies further believe that consideration of the purpose and intent of transactions that effectively hedge or reduce the risks associated with credit risk retention would undermine the hedging prohibition and the purpose and intent of section 15G.

Regarding commenters' requests to clarify the phrase ''materially related to the credit risk'' in the hedging prohibition, the agencies expect the sponsor of a tender option bond issuance to make that determination based on the relevant facts and circumstances. To the extent that the sponsor of a tender option bond issuance holds ABS interests or tax exempt municipal securities in excess of the minimum requirement under the final rule, then such sponsor would be permitted to hedge such excess interests, but must hold ABS interests or tax exempt municipal securities unhedged in an amount that satisfies the minimum risk retention requirements applicable to such retained risk.

The final rule does not include the requirement that the tender option bonds issued by a qualified tender option entity be eligible assets under Rule 2a-7 under the Investment Company Act. The agencies were persuaded by commenters that analyzing compliance with such a requirement would involve an assessment of information that might not be available to sponsors and was unnecessary given the other conditions to the sponsors' ability to rely on the risk retention options specific to tender option bonds.

The agencies are adopting the proposed disclosure requirements for qualified tender option bonds with some clarification and a minor addition. Based on comments, the agencies have added specific disclosure requirements for sponsors that retain municipal securities outside of the qualified tender option bond entity that are limited to the name and form of organization of the qualified tender option bond entity, the identity of the issuer of the municipal securities, the face value of the municipal securities deposited into the qualified tender option bond entity, and the face value of the municipal securities retained by the sponsor or its majority-owned affiliates and subject to the hedging prohibition.

Also, in response to commenters' requests for clarification of the disclosure obligations of a sponsor of a tender option bond issuance, the agencies believe that the sponsor of a tender option bond that holds a residual interest that meets the requirements of section 10(c) of the final rule should provide the disclosures required in section 4(c) of the final rule for both an eligible horizontal residual interest and an eligible vertical interest.

Under the final rule, the issuing entity of a qualified tender option bond must have a legally binding commitment from a regulated liquidity provider to provide 100 percent liquidity coverage with respect to all of the issuing entity's

outstanding tender option bonds.[207] In response to commenters' requests for certain clarifications with respect to the required liquidity coverage, the agencies recognize that the liquidity coverage may not be enforceable against the regulated liquidity provider upon the occurrence of a tender option termination event. Liquidity coverage subject to this condition would nevertheless satisfy the liquidity coverage requirement in the final rule.

As commenters requested, the final rule also permits the sponsor of a qualified tender option bond entity to combine the tender option bond risk retention options with each other and the other risk retention options under subpart B of the final rule. In any such case, the sum of the percentages of risk retention held under each option and measured in accordance with that option must total at least five. For example, if a sponsor securitizes $100 million face value of bonds in a qualified tender option bond entity and holds bonds outside the tender option structure whose face value is $3 million or 3 percent of the face value of the bonds in the qualified tender option bond entity, it must hold a residual interest in the structure that has a fair value of at least 2 percent of the fair value of all ABS interests issued by the structure (the 3 percent plus the 2 percent when aggregated equal 5 percent of the fair value). The final rule does not require a minimum amount of risk retention in any specific risk retention option, only that the sum of the percentages of risk retention totals at least 5 percent of the fair value. The agencies believe that permitting this flexibility better enables sponsors of tender option bonds to use the options afforded under the final rule.

The final rule requires the sponsor to calculate the fair value of all ABS interests issued upon an issuance of tender option bonds that increases the face amount of tender option bonds then outstanding. The agencies believe that this approach appropriately balances the costs of determining the fair value of the tender option bond residual interest with the statutory requirement for risk retention. This means that a sponsor of an issuance of tender option bonds that would like to receive credit under the final rule for retaining a residual interest in the qualifying tender option bond entity would calculate the fair value of the residual interest in the qualifying tender option bond entity in connection with the initial issuance of tender option bonds in accordance with section 10 of the final rule and would not be required to recalculate the fair value of such residual interest unless either the face value of tender option bonds outstanding exceeds the face value of bonds initially issued.

C. Allocation to the Originator

1. Overview of Proposal and Public Comment

As a general matter, the original proposal and reproposal were structured so that the sponsor of a securitization transaction would be solely responsible for complying with the risk retention requirements established under section 15G of the Exchange Act and the implementing regulations, consistent with that statutory provision. However, subject to a number of considerations, section 15G authorizes the agencies to allow a sponsor to allocate at least a portion of the credit risk it is required to retain to the originator(s) of securitized assets.[208] Accordingly, subject to conditions and restrictions, the reproposal (like the original proposal) would have permitted a sponsor to reduce its required risk retention obligations in a securitization transaction by the portion of risk retention obligations assumed by one or more of the originators of the securitized assets.

When determining how to allocate the risk retention requirements, the agencies are directed to consider whether the assets sold to the sponsor have terms, conditions, and characteristics that reflect low credit risk; whether the form or volume of the transactions in securitization markets creates incentives for imprudent origination of the type of loan or asset to be sold to the sponsor; and the potential impact of the risk retention obligations on the access of consumers and businesses to credit on reasonable terms, which may not include the transfer of credit risk to a third party.[209]

In the reproposal, the agencies proposed a framework that would have permitted a sponsor of a securitization to allocate a portion of its risk retention obligation to an originator that contributed a significant amount of assets to the underlying asset pool. The agencies endeavored to create appropriate incentives for both the securitization sponsor and the originator(s) to maintain and monitor appropriate underwriting standards without creating undue complexity, which potentially could mislead investors and confound supervisory efforts to monitor compliance. Importantly, the reproposal would not have required allocation to an originator. Therefore, it did not raise the types of concerns about allocation of burden and credit availability that might arise if certain originators, such as mortgage brokers or small community banks (that may experience difficulty obtaining funding to retain risk positions), were required to fulfill a sponsor's risk retention requirement.

The allocation to originator option in the reproposal was designed to work in tandem with the standard risk retention option. Additionally, the reproposal would have permitted a securitization sponsor to allocate a portion of its risk retention obligation to any originator of the underlying assets that originated at least 20 percent of the underlying assets in the pool. The amount of the retention interest held by each originator that was allocated credit risk in accordance with the reproposal was required to be at least 20 percent, but not in excess of the percentage of the securitized assets it originated. The originator would have been required to hold its allocated share of the risk retention obligation in the same manner as would have been required of the sponsor, and subject to the same restrictions on transferring, hedging, and financing the retained interest. Thus, for example, if the sponsor satisfied its risk retention requirements by acquiring an eligible horizontal residual interest, an originator allocated risk would have been required to acquire a portion of that interest, in an amount not exceeding the percentage of securitized assets created by the originator. The sponsor's risk retention requirements would have been reduced by the amount allocated to the originator. The sponsor would have had to provide, or cause to be provided, to potential investors (and the appropriate regulators

[207] The final rule does not require any specific form of liquidity coverage. Provided that the liquidity coverage will cover an amount sufficient to pay 100 percent of the principal outstanding and interest payable on the tender option bonds, the final rule permits liquidity coverage structured as a guarantee, credit enhancement or credit support with respect to the underlying securities or the floaters or an irrevocable put option.

[208] As discussed above, 15 U.S.C. 78o–11(a)(4) defines the term ''originator'' as a person who, through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and who sells an asset directly or indirectly to a securitizer (*i.e.,* a sponsor or depositor).

[209] 15 U.S.C. 78o–11(d)(2). The agencies note that section 15G(d) appears to contain an erroneous cross-reference. Specifically, the reference at the beginning of section 15G(d) to ''paragraph (c)(1)(E)(iv)'' is read to mean ''paragraph (c)(1)(G)(iv)'', as the former paragraph does not pertain to allocation, while the latter is the paragraph that permits the agencies to provide for the allocation of risk retention obligations between a securitizer and an originator in the case of a securitizer that purchases assets from an originator.

upon request) the name and form of organization of any originator that will acquire and retain (or has acquired and retained) an interest in the transaction, including a description of the form, amount, and nature of the interest (*e.g.,* senior or subordinated), as well as the method of payment for such interest. Finally, the reproposal would have made the sponsor responsible for any failure of an originator to abide by the transfer, hedging, and financing restrictions included in the proposed rule.

Comments on the allocation to originator proposal focused on the 20 percent threshold for allocation, the requirement that an originator to which risk retention was allocated share pro rata in all of the losses allocated to the type of interest (*i.e.,* horizontal or vertical) it holds rather than only the losses on assets that it originated, and the definition of originator. Some of the commenters requested that the 20 percent minimum should be deleted and that it would hurt smaller originators while one commenter supported the limit and asserted that it protected smaller originators. Comments as to the required pro rata sharing by the originator included an analysis that because securitization tranches are developed so that tranche holders share *pari passu* in losses, it would cause unnecessary complexity to limit an originator's interests to the loans that it had originated. Finally, a commenter asserted that the definition of ''originator'' ought to include parties that purchase assets from entities that create the assets.

2. Final Rule

The agencies have carefully considered the concerns raised by commenters with respect to the reproposal on allocation to originators. For the reasons discussed below, the agencies have concluded that the changes to the reproposal suggested by the commenters are not necessary or appropriate. Therefore, the agencies are adopting the proposed allocation to originator provision with minor drafting corrections and changes, as discussed below.

The only modifications to this option from that proposed in the reproposal are a drafting correction and changes to the formulation in section 11(a)(1)(ii) of the rule of the limit on how much of its risk retention obligation a sponsor may allocate to an originator. These changes to section 11(a)(1)(ii) of the rule reflect that no fair value computation is required for a vertical interest (discussed above in Part III.B.1 of this Supplementary Information) and, consequently, that in certain circumstances the fair value of the retained interest as a percentage of all ABS interests issued in the securitization transaction may not be determined. This change to the text of section 11(a)(1)(ii) of the rule does not result in any substantive change to the allocation to originator provisions contained in the reproposal.

While section 11(a)(1)(iv) is unchanged from the reproposal, it should be noted that the amount that is required to be paid by the originator might need to be calculated differently from how this amount would have been calculated under the reproposal. In the event that the fair value of all ABS interests issued in a securitization transaction is not calculated, which would be the case if the sponsor opted for all of its required risk retention to be held as eligible vertical interests and one or more classes of ABS interests were not sold to investors, the amount by which the sponsor's risk retention is reduced by the sale of a portion thereof to an originator will not be determinable from the calculations required by section 4 of the rule. In this circumstance, the agencies would expect that the value of the retained portion of any unsold tranches for purposes of section 11 of the rule will be determined on a reasonable basis by the sponsor and the originator.

The agencies note that the reference in section 11(a)(1)(ii) of the rule to the interest retained by the sponsor refers to the amount of the interest required to be retained by the sponsor before giving effect to any sale to an originator. Similarly, the provision in section 11(a)(2) of the rule that a sponsor disclose the percentage of the interest sold to an originator is intended to require calculation of such percentage based on the sponsor's risk retention amount before any sale to an originator.

The rule, like the proposal, requires that an originator to which a portion of the sponsor's risk retention obligation is allocated acquire and retain eligible vertical interests or eligible horizontal residual interests in the same manner as would have been retained by the sponsor. As under the reproposed rule, this condition will require an originator to acquire horizontal and vertical interests in the securitization transaction in the same proportion as the interests originally to be retained by the sponsor. This requirement helps to align the interests of originators and sponsors, as both will face the same likelihood and degree of losses if the securitized assets begin to default. In addition, if originators were permitted to retain their share of the sponsor's risk retention obligation in a proportion that is different from the sponsor's mix of the vertical and horizontal interests, investor and regulatory monitoring of risk retention compliance could become very complex.

As under the reproposal, the rule requires a sponsor that uses an eligible horizontal cash reserve account and desires to allocate a portion of its risk retention obligations to an originator to allocate a portion of the interest the sponsor holds in such account to the originator. Such allocation may be effected by any method that results in the sponsor and each originator to which any retention is allocated sharing, directly or indirectly, on a *pari passu* basis in one or more eligible horizontal residual accounts. For example, (1) the originator may deposit into the sponsor-established account funds in the amount of the originator's share of the sponsor's risk retention obligations, in replacement of a like amount of the funds originally deposited by the sponsor, or (2) the originator may create a separate horizontal reserve account in the amount of its share of the sponsor's risk retention obligations, in substitution for a like amount of funds in the sponsor's reserve account. If an originator establishes a separate account, such account must share *pari passu* with the sponsor's eligible horizontal reserve account (and any other originator's eligible horizontal reserve account) in amounts released to satisfy amounts due on ABS interests.

The rule does not modify the requirement that an originator to which a sponsor may sell a portion of its required risk retention must have originated at least 20 percent of the asset pool. As explained in the reproposal, by limiting this option to originators that originate at least 20 percent of the asset pool, the agencies seek to ensure that the originator retains risk in an amount significant enough to function as an actual incentive for the originator to monitor the quality of all the securitized assets (and to which it would retain some credit risk exposure). In addition, the 20 percent threshold serves to make the allocation option available only for entities whose assets form a significant portion of a pool and who, thus, ordinarily could be expected to have some bargaining power with a sponsor.

By restricting originators to holding no more than their proportional share of the risk retention obligation, the rule seeks to prevent sponsors from circumventing the purpose of the risk retention obligation by transferring an outsized portion of the obligation to an originator that may have been seeking to

acquire a speculative investment. These requirements are also intended to reduce the rule's potential complexity and facilitate investor and regulatory monitoring.

The rule does not incorporate the commenter suggestion that an originator be allocated retention in only the loans that it originated. The operational burden on both securitization sponsors and federal supervisors to ensure that retention is held by originators on the correct individual loans would, for many different asset classes, be exceedingly high. Therefore, the rule requires that originators allocated a portion of the risk retention requirement be allocated a share of the entire securitization pool.

The rule does not modify the definition of originator from that set forth in the reproposal and does not include persons that acquire loans and transfer them to a sponsor. The agencies continue to believe that the definition of the term originator in section 15G [210] should not be interpreted to include such persons. Section 15G defines an originator to a person that ''through the extension of credit or otherwise, creates a financial asset.'' A person that acquires an asset created by another person would not be the ''creator'' of such asset.

Finally, while the final rule omits the proposed requirement that a sponsor disclose the dollar amount of the interests sold to originators because such amount may not always be calculated, the disclosure requirements of the sponsor under section 4 of the final rule remain applicable to the sponsor and should be construed to refer to the required interest originally retained by the sponsor, even where the sponsor sells some or all of its required retained interests to originators.

D. Hedging, Transfer, and Financing Restrictions

1. Overview of the Reproposal and Public Comment

Section 15G(c)(1)(A) provides that the risk retention regulations shall prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset. Consistent with this statutory directive, the reproposal would have prohibited a sponsor from (i) transferring any interest or assets that it was required to retain under the rule to any person other than a majority-owned affiliate of the sponsor, (ii) hedging the credit risk the sponsor is required to retain under the rule, unless the hedge positions are expressly permitted or not materially related to the credit risk of the particular ABS interests or exposures required to be retained by the sponsor, or (iii) pledging as collateral for any obligation any interest or asset that the sponsor is required to retain, unless the pledge collateralizes an obligation with full recourse to the sponsor or a consolidated affiliate.

The agencies did not receive any comments directly addressing the financing restrictions in the reproposal. Several commenters addressed the hedging and transfer provisions.

While some commenters supported the proposed restrictions on hedging, others opposed the provisions as being overly restrictive, and certain commenters requested clarification as to the scope of the proposed restrictions. One commenter advocated a blanket exception from the hedging restriction for pool and asset level credit insurance reasoning that such insurance reduces credit risk for the benefit of all holders of ABS interests, and does not eliminate the retaining sponsor's exposure to credit risk or change the ''relative distribution of risk among interest holders.'' Another commenter expressed the view that issuers of securities collateralized by ''qualifying assets'' should be able to hold hedges, insurance policies and other forms of credit enhancement as discussed in Items 1114 and 1115 of the Commission's Regulation AB, and asserted that ''interest rate hedges, bond insurance policies, pool insurance policies and other forms of credit enhancement form an important component of many securitization structures and provide clear benefits to investors.''

Several commenters requested that the agencies clarify that the term ''servicing assets'' (which are generally permitted to be held by issuers) includes hedge instruments. One of these commenters asserted that the preamble to the reproposal indicated that the term was intended to be defined broadly and included ''interest rate and foreign currency risk'' hedges, but the definition of the term in the proposed regulation did not reflect that breadth. The commenter expressed concern that, without clarification, issuers that used other types of hedges would not be able to avail themselves of exemptions from risk retention, with the result that costs would be borne by investors (in the form of less credit enhancement) and borrowers (in the form of higher interest rates). Another commenter requested that permitted hedging activities include ''purchasing or selling a security or other financial instrument to protect or mitigate credit risk in servicing assets for the protection of all investors.'' This commenter requested that hedges to mitigate risk with respect to amounts due for services that are not financed as well as vehicle leases be allowed.

One commenter suggested that the agencies consider whether the restriction prohibiting the sponsor from transferring, selling, or otherwise encumbering its interest for a period of time after establishing the securitization entity may have the unintended consequence of creating a de facto agency relationship between the sponsor and the other investors in the securitization entity under GAAP. The commenter asserted that a de facto agency relationship between the sponsor and the other investors in a securitization entity results in a higher likelihood that the sponsor would be required to consolidate the securitization entity.

2. Final Rule

The agencies have carefully considered the comments received with respect to the reproposal's hedging, transfer, and financing restrictions, and for the reasons discussed below, do not believe that any significant changes to the reproposal's restrictions are necessary or appropriate. Accordingly, the final rule contains hedging, transfer, and financing restrictions that are substantially the same as those contained in the reproposal.[211]

The final rule prohibits a sponsor or any affiliate from hedging the credit risk the sponsor is required to retain under the rule or from purchasing or selling a security or other financial instrument, or entering into an agreement (including an insurance contract), derivative or other position, with any other person if: (i) Payments on the security or other financial instrument or under the agreement, derivative, or position are materially related to the credit risk of one or more particular ABS interests that the retaining sponsor is required to retain, or one or more of the particular securitized assets that collateralize the asset-backed securities; and (ii) the security, instrument, agreement, derivative, or position in any way reduces or limits the financial exposure of the sponsor to the credit risk of one or more of the particular ABS interests or one or more of the particular

[210] 15 U.S.C. 78o–11(a)(4).

[211] The sunset on hedging and transfer restrictions is discussed in Part III.F of this Supplementary Information.

securitized assets that collateralize the asset-backed securities.[212]

As in the reproposal, because the agencies believe it would not be ''materially related'' to the particular interests or assets that the sponsor is required to retain, holding a security tied to the return of an index (such as the subprime ABX.HE index) is not a prohibited hedge so long as: (1) any class of ABS interests in the issuing entity that were issued in connection with the securitization transaction and that are included in the index represent no more than 10 percent of the dollar-weighted average of all instruments included in the index, and (2) all classes of ABS interests in all issuing entities that were issued in connection with any securitization transaction in which the sponsor was required to retain an interest pursuant to the rule and that are included in the index represent, in the aggregate, no more than 20 percent of the dollar weighted average of all instruments included in the index. Such permitted positions include hedges related to overall market movements, such as movements of market interest rates (but not the specific interest rate risk, also known as spread risk, associated with the ABS interest that is otherwise considered part of the credit risk), currency exchange rates, home prices, or the overall value of a particular broad category of asset-backed securities.

In response to comments, the agencies also note that they do not believe that the rule prohibits the retaining sponsor from benefiting from credit enhancements or risk mitigation products that are designed to benefit all investors in the securitization in which the sponsor is required to retain risk. For example, the retaining sponsor may benefit from private mortgage insurance provided that the proceeds of such insurance are subject to the priority of payments for all investors.

The agencies caution that a sponsor would not be in compliance with the rule if it were to engage in, direct or control a series of transactions designed to add credit enhancement to assets ultimately securitized by it in a manner that indirectly achieved what the sponsor is prohibited from doing directly. The agencies believe that the hedging and transfer prohibitions in the statute are intended to ensure that the sponsor retains meaningful credit exposure to the securitized assets rather than credit exposure to a third party. As a result, the agencies believe that the hedging prohibition would impose limits on a sponsor benefitting from asset-level or pool-level insurance that covered 100 percent of the credit risk of the securitized assets, unless the sponsor's right to recover insurance proceeds from such hedges is subordinated to the payment in full of all other investors.

A different approach is applicable when risk reducing transactions or instruments cover either the ABS interests required to be retained by the sponsor, such as bond insurance, or 100 percent of the credit risk of the securitized assets, such as municipal bond insurance. Under this approach, the retaining sponsor would be precluded from receiving distributions that, but for the proceeds from the insurance, would not be available for distribution to that retaining sponsor unless, at the time of distribution, all other amounts due at that time to be paid to all other holders of outstanding ABS interests have been paid in full. Accordingly, until all other holders of obligations issued as part of the securitization transaction are paid all amounts then due to them, a holder of an eligible vertical interest would not be permitted to benefit from bond insurance on a senior class or tranche and, thus, would be required to subordinate its interest in any bond insurance proceeds to the payment of all amounts due to all other ABS interests. Similarly, a sponsor would not be entitled to benefit from a pool insurance policy that references amounts payable to a specific tranche or class of ABS interest unless, at the time of distribution, all other ABS interests had been paid all amounts due to them at the time.

The agencies are clarifying that the liquidity support provided by a regulated liquidity provider in satisfaction of the requirements set forth in the tender option bond risk retention option described in section 10 of the final rule or in satisfaction of the requirements set forth in the ABCP risk retention option described in section 6 of the final rule is not subject to the prohibition on hedging and transfer.[213] In both cases, the liquidity support is an important aspect of the existing market practice and alignment of interests in these transactions. The agencies note that, to the extent that a sponsor of an ABCP conduit or tender option bond program is also the liquidity provider, a liquidity agreement or credit guarantee would not violate the prohibition on hedging because such an agreement would not hedge the sponsor's credit risk retention. Additionally, with respect to an eligible ABCP conduit, the originator-seller in its capacity as sponsor of the intermediate SPV is subject to the hedging prohibition and would remain exposed to the credit risk of the collateral supporting the ABS interests issued by the intermediate SPV.

As under the reproposal, because the agencies believe that they would not be ''materially related'' to the particular interests or assets that the sponsor is required to retain, hedges tied to securities that are collateralized by similar assets originated and securitized by other sponsors would not be prohibited. On the other hand, a security, instrument, derivative or contract generally would be ''materially related'' to the particular interests or assets that the sponsor is required to retain if the security, instrument, derivative or contract refers to those particular interests or assets or requires payment in circumstances where there is or could reasonably be expected to be a loss due to the credit risk of such interests or assets (*e.g.,* a credit default swap for which the particular interest or asset is the reference asset).

In response to comments requesting clarification as to whether servicing assets could be hedged, the agencies are of the view that cash equivalents that are servicing assets should be specifically limited so that they do not create additional risk for a securitization transaction and they should not require hedging.[214] As for whether servicing assets may include hedge instruments, the agencies note that interest rate and foreign currency hedges are not prohibited hedges under section 12 of the final rule. As noted earlier, the term ''servicing assets'' is similar to the definition of the term ''eligible assets'' under Rule 3a–7 of the Investment Company Act.

Regarding commenters' concerns that the rule's transfer and hedging restrictions may create a de facto agency relationship between the sponsor and the other investors in the securitization entity under GAAP, the Commission notes, and the other agencies concur, that a de facto agency relationship

[212] The two-part test requires that a position be both ''materially related to the credit risk'' and actually offset credit risk. These concepts are often interrelated and, if significant amounts of credit risk are offset, this may indicate a material relationship to the retained ABS interests.

[213] Because a liquidity facility is required for the ABCP option and the qualified tender option bond entity options, but does not itself constitute required risk retention, it is not subject to the transfer or hedging restrictions.

[214] One notable exception might arise for cash held in a currency different than the currency of obligation for the securitization, where the amount of currency and time to payment obligation are material from the standpoint of the securitization; however this foreign exchange risk is more commonly hedged at the securitized asset level.

under GAAP will not be created by the transfer, hedging, or financing restrictions in the final rule, and note that the definition of a de facto agency relationship in GAAP relates to an agreement between variable interest holders in an entity that restricts one variable interest holder from selling, transferring, or encumbering its interest in the entity without the prior approval of other variable interest holders. A de facto agency relationship does not exist solely as a result of a regulatory restriction imposed on an investor that prohibits its ability to transfer, sell, or otherwise encumber its interest in an entity. As such, the Commission confirms, and the other agencies concur, that the restriction in the final rule prohibiting the sponsor from transferring, selling, or otherwise encumbering its interest for a period of time after establishing the securitization entity does not create under GAAP a de facto agency relationship between the sponsor and the other investors in the securitization entity.

E. Safe Harbor for Certain Foreign-Related Securitizations

Like the original proposal, the reproposal included a ''safe harbor'' provision for certain securitization transactions with limited connections to the United States and U.S. investors.[215] The safe harbor was intended to exclude from the risk retention requirements transactions in which the effects on U.S. interests are sufficiently remote so as not to significantly impact underwriting standards and risk management practices in the United States or the interests of U.S. investors. Accordingly, reliance on the safe harbor is conditioned upon limited involvement by persons in the United States with respect to both securitized assets and the ABS interests sold in connection with the transaction. The safe harbor would not have been available for any transaction or series of transactions that, although in technical compliance with the conditions of the safe harbor, is part of a plan or scheme to evade the requirements of section 15G of the Exchange Act and these rules.

Under the reproposal, the risk retention requirement would not have applied to a securitization transaction if: (1) the securitization transaction is not required to be and is not registered under the Securities Act; (2) no more than 10 percent of the dollar value (or equivalent if denominated in a foreign currency) of all classes of ABS interests in the securitization transaction are sold or transferred to U.S. persons or for the account or benefit of U.S. persons;[216] (3) neither the sponsor of the securitization transaction nor the issuing entity is (i) chartered, incorporated, or organized under the laws of the United States, or a U.S. state, the District of Columbia, Puerto Rico, the Virgin Islands or any other possession of the United States (any such state, other jurisdiction or possession, a ''U.S. state''), (ii) an unincorporated branch or office (wherever located) of an entity chartered, incorporated or organized under the laws of the United States or any U.S. state, or (iii) an unincorporated branch or office located in the United States or any U.S. state (an ''unincorporated U.S.-located entity'') of an entity not chartered, incorporated, or organized under the laws of the United States, or a U.S. state; and (4) no more than 25 percent of the assets collateralizing the ABS interests sold in the securitization transaction were acquired by the sponsor or issuing entity, directly or indirectly, from (i) a majority-owned affiliate of the sponsor or issuing entity that is chartered, incorporated or organized under the laws of the United States or a U.S. state, or (ii) an unincorporated U.S.-located entity of the sponsor or issuing entity.

Commenters on the reproposal generally supported the existence of a safe harbor for certain foreign securitizations. A few commenters suggested increasing the 10 percent limit on the value of ABS interests permitted to be sold to or for the account of U.S. persons. These commenters also requested that the agencies clarify that the 10 percent limit applies only at the time of initial issuance and does not include secondary market transfers. Commenters also proposed to exclude from the 10 percent limitation (A) securitization transactions with a sponsor or issuing entity that is a U.S. person which makes no offers to U.S. persons and (B) issuances of asset-backed securities that comply with Regulation S of the Securities Act.

Several commenters requested that the rule provide for coordination of the rule's risk retention requirement with foreign risk retention requirements, including by permitting a foreign issuer to comply with home country or other applicable foreign risk retention rules. In this regard, comment was made that U.S. risk retention rules may be incompatible with foreign risk retention requirements, such as the European Union risk retention requirements and, accordingly, that sponsors required to comply with U.S. as well as foreign risk retention regulations could be subject to conflicting rules. Commenters also requested that the agencies clarify how the dollar value of ABS interests should be determined and that satisfaction of conditions to the safe harbor be tested as of the date of issuance only and not on an ongoing basis.

The final rule sets forth a foreign safe harbor that is substantially similar to that included in the reproposal. The agencies have retained the 10 percent limit on the value of ABS interests sold to U.S. persons for safe harbor eligibility. The agencies continue to believe that the 10 percent limit appropriately aligns the safe harbor with the objective of the rule, which is to exclude only those transactions with limited effect on U.S. interests, underwriting standards, risk management practices, or U.S. investors.

The agencies wish to make clear that, in general, the rule is intended to include in the calculation of the 10 percent limit only ABS interests sold in the initial distribution of ABS interests. Secondary sales to U.S. persons would not normally be included in the calculation. However, secondary sales into the U.S. under circumstances that indicate that such sales were contemplated at the time of the issuance (and not included for purposes of calculating the 10 percent limit) might be viewed as part of a plan or scheme to evade the requirements of the rule.

The 10 percent limit as applied to the sale or transfer of any ABS interest would need to be computed only on the date of initial distribution of that ABS interest, not an ongoing basis following such initial distribution. If different classes or portions of the same class of ABS interests are distributed by or on behalf of the issuing entity or a sponsor on different dates, the 10 percent limit would need to be calculated on each such distribution date.

Under the rule, interests retained by the sponsor may be included, as part of the aggregate ABS interests in the securitization transaction, in calculating the percentage of those ABS interests sold to U.S. persons or for the account or benefit of U.S. persons.

The agencies considered the comments requesting a mutual recognition framework and observe that

[215] As the agencies noted in the original proposal, the safe harbor is intended solely to provide clarity that the agencies will not apply the requirements of the final rule to transactions that meet all of the conditions of the safe harbor. The safe harbor should not be interpreted as reflecting the views of any agency as to the potential scope of transactions or persons subject to section 15G or the final rule.

[216] The agencies note that the value of an ABS interest for this purpose would be its fair value on the date of sale, determined using the fair value measurement framework under GAAP.

such a framework has not been generally adopted in non-U.S. jurisdictions with risk retention requirements. As explained in the preamble to the proposed rule, given the many differences between jurisdictions, such as securitization frameworks that place the obligation to comply with risk retention requirements upon different parties in the securitization transaction, different requirements for hedging, risk transfer, or unfunded risk retention, and other material differences, the agencies believe that it would likely not be practicable to construct such a ''mutual recognition'' system that would meet all the requirements of section 15G of the Exchange Act. Moreover, in several such jurisdictions, the risk retention framework recognizes unfunded forms of risk retention, such as standby letters of credit, which the agencies do not believe provide sufficient alignment of incentives and have rejected as eligible forms of risk retention under the U.S. framework. Finally, the agencies believe that the rule incorporates sufficient flexibility for sponsors with respect to forms of eligible risk retention to permit foreign sponsors seeking a significant U.S. investor base to retain risk in a format that satisfies applicable foreign and U.S. regulatory requirements, even though such dual compliance requirements might cause a sponsor to structure a transaction differently than it would have chosen had it not been subject to such multiple requirements.

The agencies do not agree that securitizations with U.S. persons, sponsors or issuing entities with no U.S. offerees, or that conduct all sales pursuant to Regulation S of the Securities Act, should be exempt from the 10 percent limit. If the rule excluded such securitizations or sales from the 10 percent limit, a market for poorly underwritten assets could evolve and negatively impact U.S. underwriting standards and risk management practices.

Improving underwriting standards is one of the goals of risk retention and, for the rule to be effective, the rule should be applied in a manner that maintains underwriting standards and risk management practices in the United States. The agencies' adoption of the foreign safe harbor incorporates the agencies' understanding of current securitization markets and market trends, including the importance of U.S. investors in global securitization markets. As securitization markets evolve, the agencies will be alert to ensuring any such changes do not undermine the effectiveness of the rule in achieving the purposes of section 15G. Accordingly, the agencies will monitor compliance with the safe harbor and the contexts in which the safe harbor is relied upon. Should it become apparent that reliance on the safe harbor has resulted in market shifts that are detrimental to investors or securitization markets, for example where significant amounts of securitizations collateralized by U.S. assets are conducted in reliance on the safe harbor and such reliance undermines underwriting standards and risk management practices in the United States, the agencies will consider the applicability of the anti-evasion provisions of the safe harbor or will consider modifications to the safe harbor.

F. Sunset on Hedging and Transfer Restrictions

As discussed in Part III.D of this Supplementary Information, section 15G(c)(1)(A) of the Exchange Act provides that sponsors may not hedge or transfer the risk retention interest they are required to hold.[217] However, the statute also provides that the agencies shall specify the minimum duration of risk retention. As explained in the reproposal, the agencies believe that the primary purpose of risk retention—sound underwriting—is less likely to be effectively promoted by risk retention requirements after a certain period of time has passed and a peak number of delinquencies for an asset class has occurred. Therefore, the agencies proposed two categories of duration for the transfer and hedging restrictions—one for RMBS and one for other types of ABS interests.

For RMBS, the transfer and hedging restrictions under the proposed rule would expire on or after the date that is (1) the later of (a) five years after the date of the closing of the securitization or (b) the date on which the total unpaid principal balance of the securitized assets is reduced to 25 percent of the original unpaid principal balance as of the date of the closing of the securitization, but (2) in any event no later than seven years after the date of the closing of the securitization.

For all ABS interests other than RMBS, the transfer and hedging restrictions under the reproposed rule would expire on or after the date that is the latest of (1) the date on which the total unpaid principal balance of the securitized assets that collateralize the securitization is reduced to 33 percent of the original unpaid principal balance as of the date of the closing of the securitization, (2) the date on which the total unpaid principal obligations under the ABS interests issued in the securitization is reduced to 33 percent of the original unpaid principal obligations at the closing of the securitization transaction, or (3) two years after the date of the closing of the securitization transaction.[218]

The reproposal also included a provision that the proposed rule's restrictions on transfer and hedging would end if a conservator or receiver of a sponsor or other holder of risk retention is appointed pursuant to federal or state law.

The agencies invited comment on the sunset provisions and asked whether they were appropriately calibrated for RMBS and all other asset classes, and whether it was appropriate to provide a sunset provision for all RMBS. Several commenters expressed general support for the sunset provisions but others requested shorter time period restrictions. One commenter suggested longer time period restrictions on certain asset classes, while others proposed shortening the time periods and adding more flexibility. One commenter suggested that there should be an outside time limit of no more than five years for asset classes other than RMBS and CMBS, including student loans, aircraft leases, shipping container leases, railcar leases, and structured settlements of personal injury awards, lottery winnings, and other assets. A few commenters requested clarification for transactions that do not typically have a nominal ''principal balance'' and one commenter requested that the test use the cut-off date instead of the closing date for measurement.

For RMBS, a few commenters requested that sunset occur three to four years after closing, while another commenter requested a sunset of two years after the security is issued. One commenter recommended that the agencies adopt a flat five-year sunset for RMBS and eliminate the 25 percent remaining unpaid balance test. In support of a three-year sunset after closing, some commenters requested that the RMBS sunset provision be analogous to the FHFA framework for

[217] 15 U.S.C. 78o–11(c)(1)(A). As with other provisions of risk retention, the agencies could provide an exemption under section 15G(e) of the Exchange Act if certain findings were met. *See id.* at section 78o–11(e).

[218] As described in Part III.B.5 of this Supplementary Information, the agencies also included in the reproposal, as an exception to the transfer and hedging restrictions, the ability to transfer the retained B-piece interest in a CMBS transaction (whether held by the sponsor or a third-party purchaser) to a third-party purchaser five years after the date of the closing of the securitization transaction, provided that the transferee satisfies each of the conditions applicable to an initial third-party purchaser under the CMBS option.

representations and warranties whereby lenders are relieved of certain repurchase obligations for loans after 36 months of on-time payments. One commenter requested that the sunset provisions be calibrated differently depending on the risk associated with the underlying RMBS.

A few commenters recommended a two-year sunset provision for open market CLOs, noting that anything longer would provide no relief given the fact that these pools allow for reinvestment. Two commenters requested alternative sunset provisions for student, vehicle, and equipment loans where sunset would occur on the earlier of (i) two years after the closing date, and (ii) the later of (A) the reduction of the unpaid principal balance of the securitized assets to 33 percent or less of the cut-of date balance and (B) the reduction of the unpaid principal balance of the ABS interests sold to third parties to 33 percent or less of the closing date balance.

The agencies have carefully considered the comments and are adopting the sunset provisions as proposed. In reviewing the reproposal and the comments, the agencies considered the duration for which the rule should maintain the sponsor's exposure to the performance of the assets, balancing the time it might take for weaker underwriting to manifest itself against the competing consideration that, as that time period extends, other factors may be more influential triggers of asset default. Although the time periods proposed by the agencies are longer than commenters generally asserted were necessary in striking this balance, the agencies seek to establish a conservative approach. It is expected that this approach will cause sponsors to focus on underwriting criteria on the front end, at the time of securitization, and the agencies believe that requiring them to be mindful of their exposure for the periods the agencies proposed will improve the sponsor's alignment of incentives and reinforce their focus on the performance of their assets beyond their initial creation. Accordingly, with respect to the proposed risk retention duration requirements for RMBS and for non-residential mortgage ABS interests, the agencies are concerned that reducing the risk retention periods further would weaken the incentive for sponsors to ensure sound underwriting.

With respect to the proposed risk retention duration requirement for RMBS, as the agencies discussed in the reproposal, because residential mortgages typically have a longer duration than other assets, weaknesses in underwriting may manifest themselves later than in other asset classes and can be masked by strong housing markets. Moreover, residential mortgage pools are uniquely sensitive to adverse selection through prepayments: if market interest rates fall, borrowers refinance their mortgages and prepay their existing mortgages, but refinancing is not available to borrowers whose credit has deteriorated, so mortgages to less creditworthy borrowers become concentrated in the RMBS pool in later years. Accordingly, the agencies are maintaining a different sunset provision for RMBS collateralized by residential mortgages that are subject to risk retention.

In response to commenters who, in the context of assets other than residential mortgage loans, asked for clarification as to how the sunset provisions apply if the securitized assets do not have a principal balance, the agencies have revised the rule to clarify that the sunset criterion relating to principal balance would not apply to securitized assets that do not have a principal balance, if applicable. Thus, for such securitized assets, the rule provides that the transfer and hedging restrictions may terminate upon the later of two years after the date of the closing of the securitization transaction or the date on which the total unpaid principal balance of the issued ABS interests is reduced to 33 percent of their original balance.

In addition, the agencies continue to believe the exemptions to the prohibitions on transfer for CMBS eligible horizontal residual interests proposed in the reproposal would help ensure high quality underwriting standards for the securitizers and originators of non-residential mortgage ABS interests and CMBS, would improve the access of consumers and businesses to credit on reasonable terms, and are in the public interest and for the protection of investors.[219]

IV. General Exemptions

Sections 15G(c)(1)(G) and 15G(e) of the Exchange Act require the agencies to provide a total or partial exemption from the risk retention requirements for certain types of asset-backed securities or securitization transactions.[220]

In addition, section 15G(e)(1) permits the agencies jointly to adopt or issue additional exemptions, exceptions, or adjustments to the risk retention requirements of the rule, including exemptions, exceptions, or adjustments for classes of institutions or assets, if the exemption, exception, or adjustment would: (A) help ensure high quality underwriting standards for the securitizers and originators of assets that are securitized or available for securitization; and (B) encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of consumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors.

Consistent with these provisions, the reproposal would have exempted certain types of asset-backed securities or securitization transactions from the credit risk retention requirements of the rule. Each of these exemptions, along with the comments and the final rule that the agencies are adopting, are discussed below. The agencies have determined that each of the exemptions adopted pursuant to section 15G(e)(1), including for the reasons described below and in the reproposal, satisfy the requirements described in the preceding paragraph.

A. Exemption for Federally Insured or Guaranteed Residential, Multifamily, and Health Care Mortgage Loan Assets

Section 15G(e)(3)(B) of the Exchange Act provides that the agencies, in implementing risk retention regulations, shall not apply risk retention to any residential, multifamily, or health care facility mortgage loan asset, or securitization based directly or indirectly on such an asset, that is insured or guaranteed by the United States or an agency of the United States.[221] To implement this provision, the reproposal would have exempted from the risk retention requirements any securitization transaction collateralized solely by residential, multifamily, or health care facility mortgage loan assets if the assets are insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States.[222]

Several commenters expressed support for the exemption for securitization transactions collateralized solely by assets that are insured or guaranteed as to the payment of principal and interest by the United States or its agencies. One commenter urged the agencies to extend the government-backed exemptions to asset-backed securities backed by foreign governments. Another commenter requested that the agencies clarify that Enterprise securitizations of multifamily

[219] 15 U.S.C. 78o–11(e)(2).

[220] *See* 15 U.S.C. 78o–11(c)(1)(G) and (e).

[221] *See id.* at section 78o–11(e)(3)(B).

[222] *See id.* at section 78o–11(e)(3)(B).

loans are exempt from the risk retention requirements.

After considering the comments received, the agencies are adopting as proposed the exemption from the risk retention requirements for any securitization transaction that is collateralized solely by residential, multifamily, or health care facility mortgage loan assets if the assets are insured or guaranteed in whole or in part as to the payment of principal and interest by the United States or an agency of the United States.

The agencies are not adopting an exemption from risk retention for securitizations of assets issued, guaranteed or insured by foreign government entities. As the agencies noted in the reproposal, the agencies continue to believe that it would not be appropriate to exempt such transactions from risk retention if they were offered in the United States to U.S. investors. Nor are the agencies expanding this (or any other exemption) to include all securitizations of multifamily loans by the Enterprises. Such securitizations require risk retention under the rule unless they meet the requirements of section 8 of the rule.

B. Exemption for Securitizations of Assets Issued, Insured, or Guaranteed by the United States or any Agency of the United States and Other Exemptions

Section 15G(c)(1)(G)(ii) of the Exchange Act requires that the agencies, in implementing risk retention regulations, provide for a total or partial exemption from risk retention for securitizations of assets that are issued or guaranteed by the United States or an agency of the United States, as the agencies jointly determine appropriate in the public interest and the protection of investors.[223] The reproposal would have provided full exemption from risk retention for any securitization transaction in which the ABS interests issued in the transaction were (1) collateralized solely by obligations issued by the United States or an agency of the United States and servicing assets; (2) collateralized solely by assets that are fully insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States (other than residential, multifamily, or health care facility mortgage loan securitizations discussed above) and servicing assets; or (3) fully guaranteed as to the timely payment of principal and interest by the United States or any agency of the United States.

Consistent with section 15G(e)(3)(A) of the Exchange Act, the reproposal also would have provided an exemption from risk retention for any securitization transaction collateralized solely by loans or other assets made, insured, guaranteed, or purchased by any institution that is subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation, and servicing assets.[224] Additionally, the reproposal would have provided an exemption from risk retention, consistent with section 15G(c)(1)(G)(iii) of the Exchange Act,[225] for securities (1) issued or guaranteed by any state[226] of the United States, or by any political subdivision of a state, or by any public instrumentality of a state that is exempt from the registration requirements of the Securities Act by reason of section 3(a)(2) of the Securities Act, or (2) defined as a qualified scholarship funding bond in section 150(d)(2) of the IRS Code.

One commenter requested that the final rule retain the full exemption for securities issued by a state (including a political subdivision or public instrumentality of a state), and for securities that meet the definition of a qualified scholarship funding bond. This commenter requested clarification that the exemption for state and municipal securitizations would apply to both securities issued on a federally taxable basis and securities issued on a federal tax-exempt basis. A few commenters urged that the agencies clarify that all securities issued by housing finance agencies and other state government agencies and collateralized by loans financed by housing finance agencies are exempted.

After considering the comments received, the agencies are adopting as proposed the exemption from the risk retention requirements for any securitization transaction that is (1) collateralized solely by obligations issued by the United States or an agency of the United States and servicing assets; (2) collateralized solely by assets that are fully insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States (other than residential, multifamily, or health care facility mortgage loan securitizations discussed above) and servicing assets; (3) insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States; (4) collateralized solely by loans or other assets made, insured, guaranteed, or purchased by any institution that is subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation, and servicing assets; (5) issued or guaranteed by any state of the United States, or by any political subdivision of a state, or by any public instrumentality of a state that is exempt from the registration requirements of the Securities Act by reason of section 3(a)(2) of the Securities Act; or (6) defined as a qualified scholarship funding bond in section 150(d)(2) of the IRS Code.

Regarding whether the exemption for state and municipal securitizations would apply to both securities issued on a federally taxable basis and securities issued on a federal tax-exempt basis, the agencies note that the text of the exemption does not specifically make a distinction between taxable and tax-exempt securities. To the extent that a security otherwise satisfies the requirements of the state and municipal securitizations exemption, such security is exempt from the risk retention rule.

The agencies are exempting loans that are exempt from the ability-to-repay requirements (such as loans made through state housing finance agency programs and certain community lending programs) that were not separately included in the definition for QRM (which under the statute cannot be broader than QM) and would only be QRMs if they otherwise met the qualifying criteria for QMs. This exemption is discussed more fully below.

C. Federal Family Education Loan Program and Other Student Loan Securitizations

The reproposal would have exempted any securitization transaction that is collateralized solely (excluding servicing assets) by student loans made under the Federal Family Education Loan Program (''FFELP'') that are guaranteed as to 100 percent of defaulted principal and accrued interest (*i.e.,* FFELP loans with first disbursement prior to October 1993, or pursuant to certain limited circumstances where a full guarantee was required). A securitization transaction that is collateralized solely (excluding servicing assets) by FFELP loans that are guaranteed as to at least 98 percent (but less than 100 percent) of defaulted principal and accrued interest

[223] *See id.* at section 78o–11(c)(1)(G).

[224] *See* 15 U.S.C. 78o–11(e)(3)(A).

[225] *See id.* at section 78o–11(c)(1)(G)(iii).

[226] Section 2 of the rule defines ''state'' as having the same meaning as in section 3(a)(16) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(16)), which includes a state of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States.

would have its risk retention requirement reduced to 2 percent. Any other securitization transaction that is collateralized solely (excluding servicing assets) by FFELP loans would have its risk retention requirement reduced to 3 percent.

Several commenters urged the agencies to expand the proposed exemption for securitization transactions collateralized by FFELP loans to a full exemption from risk retention requirements. These commenters asserted that a risk retention requirement ranging from zero percent to 3 percent for FFELP loan securitizations that are subject to a guaranty ranging from 97 percent to 100 percent means risk retention is required in an amount greater than the loss exposure on the loans. These commenters stated that other securitization products would receive a full exemption under the reproposal even if they are only partially insured or guaranteed. A few of these commenters also asserted that risk retention would have no effect on the underwriting standards since these loans have already been funded and the program is no longer underwriting new loans. One of these commenters urged the agencies to apply the risk retention requirement only to the portion of the FFELP loans that are not guaranteed.[227]

Commenters also recommended that the agencies accept alternative forms of risk retention for FFELP loan securitizations. The suggested alternative forms of risk retention include a simplified representative sample method, an exemption for on-balance sheet transactions where the structure clearly demonstrates at least 5 percent risk retention, initial equity contribution, overcollateralization, and unfunded forms of risk retention. One of these commenters cited the European Union risk retention regime which recognizes certain unfunded forms of risk retention.

One commenter asked that the agencies extend the FFELP loan securitization exemption to include student loan-backed securities issued by entities exempt from registration under section 3(a)(4) of the Securities Act and by entities that have received tax-exempt designations under section 501(c)(3) of the IRS Code. This commenter asserted that these issuers are constrained in their ability to raise sufficient capital to meet the risk retention requirements. One other commenter requested that student loan revenue bonds issued by nonprofit issuers that are supported by third-party credit enhancement be exempted. This commenter asserted that investors in these bonds are not making their investment decisions based on the credit risk and performance of the asset pool, and that these bonds are assessed based on the creditworthiness and structure of the third-party credit enhancement. Another commenter requested that all nonprofit public purpose student loan providers be fully exempted from risk retention requirements. This commenter asserted that the structure of the securitizations issued by these entities, and the history of investor interest in security issuances by nonprofit organizations, reflect the strong alignment of interests between the investors and sponsors of these types of securitization transactions.

Another commenter requested clarification that the exemption for qualified scholarship funding bonds apply to both securities issued on a federally taxable basis and securities issued on a federal tax-exempt basis.

After considering the comments received, the agencies are adopting the reductions in the amount of required risk retention for FFELP loan securitization as reproposed. The agencies do not believe that providing a full exemption to partially insured or guaranteed FFELP loans is warranted. The agencies believe that the reductions in risk retention for FFELP loan securitizations described in the reproposal reflect the appropriate level of ''skin in the game'' for these transactions, encouraging high quality underwriting generally in the selection of assets for securitization and appropriate risk management practices in post-default servicing. The agencies also reiterate that they have generally declined to recognize unfunded forms of risk retention and continue to do so for purposes of the final rule.

Consistent with the reproposal, the agencies are not expanding the proposed exemptions to cover student loans other than FFELP student loans, including student loan-backed securities issued by entities exempt from registration under section 3(a)(4) of the Securities Act or entities that have received tax exempt designations under section 501(c)(3) of the IRS Code, because comments received on the reproposal did not provide a basis to allow the agencies to conclude that the structures or underwriting practices of these securitizations align the interests of securitizers with the interests of investors such that an exemption would be appropriate under section 15G(c)(1)(G) or section 15G(e) of the Exchange Act. The agencies are concerned that an exemption for sponsors of student loan-backed securities issued by entities exempt from registration under section 3(a)(4) of the Securities Act or entities that receive tax exempt designations under section 501(c)(3) of the IRS Code would permit evasion of the rule through the use of an entity that meets the requirements of such exemption, but whose sole purpose is the issuance of ABS interests. Regarding whether the exemption for qualified scholarship funding bonds would apply to both securities issued on a federally taxable basis and securities issued on a federal tax-exempt basis, the agencies note that the text of the exemption does not specifically make a distinction between taxable and tax-exempt securities. To the extent a security satisfies the requirements of the qualified scholarship funding bond exemption in the rule, such security is exempt from the risk retention rule. The agencies believe that there is not sufficient justification to provide an exemption for bonds that may have some similarities to a qualified scholarship funding bond, but do not meet the statutory definition.

D. Certain Public Utility Securitizations

The reproposal would have provided an exemption from risk retention for utility legislative securitizations. Specifically, the reproposal would have exempted any securitization transaction where the ABS interests are issued by an entity that is wholly owned, directly or indirectly, by an investor-owned utility company that is subject to the regulatory authority of a state public utility commission or other appropriate state agency. Additionally, ABS interests issued in an exempted utility legislative securitization transaction would have been required to be secured by the intangible property right to collect charges for the recovery of specified costs and such other assets of the issuing entity. The reproposal would have defined ''specified cost'' to mean any cost identified by a state legislature as appropriate for recovery through securitization pursuant to ''specified cost recovery legislation,'' which is legislation enacted by a state that:

- Authorizes the investor-owned utility company to apply for, and authorizes the public utility commission or other appropriate state agency to issue, a financing order determining the amount of specified costs the utility will be allowed to recover;
- Provides that pursuant to a financing order, the utility acquires an

[227] This commenter suggested, as an example, that if only 3 percent of a FFELP loan is uninsured, the 5 percent risk retention requirement should only apply to the 3 percent uninsured portion, resulting in a 0.15 percent risk retention requirement with respect to such loan.

intangible property right to charge, collect, and receive amounts necessary to provide for the full recovery of the specified costs determined to be recoverable, and assures that the charges are non-bypassable and will be paid by customers within the utility's historic service territory who receive utility goods or services through the utility's transmission and distribution system, even if those customers elect to purchase these goods or services from a third party; and

• Guarantees that neither the state nor any of its agencies has the authority to rescind or amend the financing order, to revise the amount of specified costs, or in any way to reduce or impair the value of the intangible property right, except as may be contemplated by periodic adjustments authorized by the specified cost recovery legislation.[228]

The agencies received no comments on the utility legislative securitization exemption, and are adopting the exemption as reproposed.

E. Seasoned Loan Securitizations

In the reproposal, the agencies proposed to exempt from risk retention any securitization transaction that is collateralized solely by servicing assets and seasoned loans that (1) have not been modified since origination and (2) have never been delinquent for 30 days or more. With respect to residential mortgages, the reproposal would have defined ''seasoned loan'' to mean a residential mortgage loan that either (1) has been outstanding and performing for the longer of (i) five years or (ii) the period until the outstanding principal balance of the loan has been reduced to 25 percent of the original principal balance; or (2) has been outstanding and performing for at least seven years. For all other asset classes, the reproposal would have defined ''seasoned loan'' to mean a loan that has been outstanding and performing for the longer of (1) two years, or (2) the period until the outstanding principal balance of the loan has been reduced to 33 percent of the original principal balance.

The agencies received a number of comments on the seasoned loan exemption from financial entities and financial trade organizations. Commenters generally favored expanding the seasoned loan exemption, although they differed in how to expand the exemption. One commenter proposed that ''seasoned loans'' be redefined to accommodate auto loans that have been outstanding and performing for the shorter of (1) two years, or (2) the period until the outstanding principal balance of the loan has been reduced to 33 percent of the original principal balance. Other commenters proposed that the exemption be expanded to accommodate certain previously modified residential mortgage loans that have not had past delinquency events.

One commenter requested that loans with delinquencies up to 60 days qualify, and another suggested that loans that have been delinquent and then brought current qualify if they perform for 36 months after the delinquency. Another commenter asked that the exception include loans that had no more than three 30-day delinquencies if the loan is otherwise performing for five years and not delinquent at the time of securitization.

Other commenters asked that the agencies permit blended securitizations of seasoned loans with other loans that require risk retention, with the amount of risk retention reduced accordingly. These commenters expressed concern of potentially fragmenting the market for these loans. However, the investor members of one commenter questioned the need to blend pools of seasoned and ''non-seasoned'' loans because ABS interests collateralized by these types of assets are unlikely to appeal to the same types of investors.

After considering the comments received, the agencies are adopting the seasoned loan exemption as reproposed. The agencies believe that there is insufficient data to justify expanding the seasoned loan exemption and that the alignment of the seasoned loan exemption with the sunset provisions on hedging and transfer enhances consistency across the provisions of the rule and better aligns the incentives of sponsors and investors. The agencies do not believe that the period of time during which a loan is required to have been outstanding to qualify as a seasoned loan should be different from the period after which the transfer and hedging restrictions sunset. Nor do they believe that loans that have at any time been more than 30 days delinquent should qualify. And, while modifications of loans for reasons other than loss mitigation might be well-underwritten loans, it would be difficult if not impossible to verify the underlying reasons for a modification. Commenters did not provide examples of securitization transactions collateralized by newly originated and seasoned loans or data or reasoned analysis to support the assertion that such transactions would fill existing needs for financing. Because the agencies are not persuaded that market fragmentation would result, the agencies are not permitting blended pools of seasoned loans and loans that would not satisfy the seasoned loan exemption.

F. Federal Deposit Insurance Corporation Securitizations

In the reproposal, the agencies proposed an exemption from risk retention for securitization transactions that are sponsored by the FDIC, acting as conservator or receiver under any provision of the Federal Deposit Insurance Act or Title II of the Dodd-Frank Act. For the reasons discussed in the reproposal,[229] the agencies continue to believe that this exemption would help ensure high quality underwriting, and is in the public interest and for the protection of investors.[230] These receivers and conservators perform a function that benefits creditors in liquidating and maximizing the value of assets of failed financial institutions for the benefit of creditors. Accordingly, their actions are guided by sound underwriting practices, and the quality of the assets will be carefully monitored in accordance with the relevant statutory authority.

One commenter expressly supported this exemption, noting, among other things, that it would help the FDIC maximize the value of assets in conservatorship and receivership. For the reasons noted above, the agencies are adopting the FDIC securitization exemption as reproposed.

G. Exemption for Certain Resecuritization Transactions

In the reproposal, the agencies proposed two different exemptions from risk retention for certain ABS interests issued in resecuritization transactions (resecuritization ABS interests).[231] The first of these exemptions would have applied to resecuritizations of asset backed securities that met certain specific conditions set forth in proposed section 19(b)(5) (pass-through resecuritizations). The second one would have applied only to resecuritizations of certain first pay classes of mortgage backed securities that met the requirements in proposed

[228] The eligibility standards for the exemption are similar to certain requirements for these securitizations outlined in IRS Revenue Procedure 2005–62, 2005–2 C.B. 507, that are relevant to risk retention. This Revenue Procedure outlines the Internal Revenue Service's requirements in order to treat the securities issued in these securitizations as debt for tax purposes, which is the primary motivation for states and public utilities to engage in such securitizations.

[229] *See* Revised Proposal, 78 FR at 57978.

[230] *See* 15 U.S.C. 78o–11(e).

[231] *See* Revised Proposal, 78 FR at 57972–57974. In a resecuritization transaction, the asset pool collateralizing the ABS interests issued in the transaction comprises one or more asset-backed securities.

section 19(b)(6) (first-pay-class resecuritization). Under the reproposal, sponsors of resecuritizations that were not structured to meet the terms of one of these two exemptions would have been required to meet the credit risk retention requirements with respect to the resecuritization transaction unless another exemption for the transaction was available.

Under the section 19(b)(5) of the reproposal, the resecuritization ABS interests would have to be collateralized solely by servicing assets and existing ABS interests issued in a securitization transaction for which credit risk was retained as required under the original proposal, or which was otherwise exempted from credit risk retention requirements (compliant ABS interests). Second, the transaction would have to be structured so that it involved the issuance of only a single class of ABS interests and provided for a pass through of all principal and interest payments received on the underlying asset-backed securities (net of expenses of the issuing entity) to the holders of such class of ABS interests. The agencies explained that because the holder of a resecuritization ABS interest structured as a single-class pass-through security would have had a fractional undivided interest in the pool of underlying asset-backed securities and in the distributions of principal and interest (including prepayments) from these underlying asset-backed securities, a resecuritization ABS interest meeting these requirements would not alter the level or allocation of credit and interest rate risk on the underlying asset-backed securities. The agencies had proposed this exemption in the original proposal and did not substantively alter it in the reproposal.

The agencies proposed to adopt this exemption under the general exemption provisions of section 15G(e)(1) of the Exchange Act. The agencies noted that a resecuritization transaction that created a single-class pass-through would neither increase nor reallocate the credit risk inherent in the underlying compliant ABS interests, and that the transaction could allow for the combination of asset-backed securities collateralized by smaller pools, and the creation of asset-backed securities that may be collateralized by more geographically diverse pools than those that can be achieved by the pooling of individual assets.

Under the first-pay-class resecuritization exemption in proposed section 19(b)(6), the agencies proposed a limited resecuritization exemption that would apply to certain resecuritizations of residential mortgage-backed securities structured to address prepayment risk, but that would not apply to a structure that re-allocated credit risk by tranching and subordination. To qualify for this proposed exemption, the transaction would have to have been a resecuritization of first-pay classes of ABS interests, which were themselves collateralized by first-lien residential mortgages on property located in a state,[232] and which were issued in transactions that complied with the risk retention rules or were exempt from the rule.[233] The reproposal also would have allowed a pool collateralizing the exempted first-pay-class resecuritization to contain servicing assets.

In addition, to qualify for the exemption, any ABS interest issued in the resecuritization would have had to share pro rata in any realized principal losses with all other ABS interests issued in the resecuritization based on the unpaid principal balance of such interest at the time the loss was realized. The transaction would have had to be structured to reallocate prepayment risk, and the proposed exemption specifically would have prohibited any structure which re-allocated credit risk (other than credit risk reallocated only as a consequence of reallocating prepayment risk). The reproposal also would have prohibited the issuance of an inverse floater or any similarly structured class of ABS interest as part of the exempt resecuritization transaction.[234]

The agencies proposed the first-pay-class resecuritization exemption in response to comments on the original proposal about liquidity in underlying markets and access to credit on reasonable terms.[235] The agencies noted that residential mortgage-backed securities tend to have longer maturities than other types of asset-backed securities and to have high prepayment risk. The agencies reasoned that the exemption would help provide investors with protection against prepayment risk and greater certainty as to expected life. The proposed exemption, however, did not divide the credit risk of the underlying asset-backed securities and therefore did not give rise to the same concerns as CDOs and other resecuritizations that involved tranching of credit risk.[236]

The agencies proposed the first-pay-class resecuritization exemption under the general exemption provisions of section 15G(e)(1) of the Exchange Act. The agencies determined that the provision was consistent with the requirements of this section, given the conditions established for the exemption. In particular, the agencies noted that the provision limited the exemption to resecuritizations of first-pay classes of residential mortgage-backed securities, and that it applied specific prohibitions on structures that re-allocate credit risk, so it minimized credit risk associated with the resecuritized residential mortgage-backed securities and prevented the transaction from reallocating existing credit risk while addressing some of the commenters' concerns with regard to liquidity and access to credit.[237]

The agencies received a number of comments on the proposed resecuritization exemptions. The comments did not raise specific objections or concerns with either of the two proposed exemptions, but generally urged regulators to expand the exemptions to other types of structures including those that re-tranche credit risk. Commenters asserted that applying risk retention to resecuritization of asset-backed securities that are already in the market, especially where the interests are compliant ABS interests, cannot alter the incentives for the original sponsor of asset-backed securities to ensure high-quality assets. Other commenters stated that the lack of a broad resecuritization exemption would negatively affect markets by

[232] Section 2 of the reproposed rule defined ''state'' as having the same meaning as in section 3(a)(16) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(16)). Thus, the ABS interests that would be resecuritized in a transaction exempted under this provision would have been required to be collateralized by mortgages on properties located in a state of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States. *See* Revised Proposal, 78 FR at 57973.

[233] The reproposal defined ''first-pay class'' as a class of ABS interests for which all interests in the class were entitled to the same priority of principal payments and that, at the time of closing of the transaction, were entitled to repayments of principal and payments of interest prior to or pro-rata, except for principal-only and interest only tranches that are prior in payment, with all other classes of securities collateralized by the same pool of first-lien residential mortgages until such class has no principal or notional balance remaining. A single class of pass-through ABS interests under which an investor would have a fractional, undivided interest in the pool of mortgages collateralizing the ABS interests would have qualified as a ''first pay class'' under this definition.

[234] The reproposal defined ''inverse floater'' as an ABS interest issued as part of a securitization transaction for which interest or other income is payable to the holder based on a rate or formula that varies inversely to a reference rate of interest. The exclusion from the proposed exemption of transactions involving the issuance of an inverse floater class addressed concerns with the high risk of loss that has been associated with these instruments. *See* Id. at 57974.

[235] *Id.* at 57973.

[236] *Id.*

[237] *Id.*

making it harder for investors to restructure and sell existing asset-backed securities. A number of commenters stated that the agencies should provide an exemption for resecuritizations of asset-backed securities that were issued prior to the applicable effective date of the rule. Still others expressed the view that the agencies could develop an exemption that would allow credit tranching in resecuritized asset-backed securities while limiting the scope of such exemption, such as by excluding actively managed pools, to address agencies' concerns regarding CDOs and similar structures. The comments were generally similar to comments received on the original proposal.

The agencies have carefully considered the comments received in conjunction with the purposes and requirements of the statute. As the agencies noted in the reproposal, sponsors of resecuritization transactions have considerable flexibility in choosing what ABS interests to include in the underlying pool of securitized assets as well as in creating the specific structures. This choice of securities is a type of underwriting choice with respect to those securities for inclusion in the underlying pool of securitized assets. The agencies continue to consider it appropriate, therefore, to adopt rules that will provide sponsors with sufficient incentive to choose ABS interests that have lower levels of credit risk and to not use a resecuritization to obscure what might have been sub-par credit performance of certain ABS interests. The agencies also continue to consider it appropriate to apply the risk retention requirements to resecuritization transactions generally because resecuritization transactions can result in a re-allocation of the credit risk of the underlying ABS interest. Such considerations are present whether or not the original underlying asset-backed securities were issued prior to the applicable effective date of these risk retention rules or are compliant with the rule.[238] The agencies also note that section 15G of the Exchange Act specifically contemplates applying risk retention to resecuritizations.[239]

Taking into account these considerations, the agencies continue to believe that requiring additional risk retention as the standard for most resecuritization transactions is consistent with the intent of section 15G of the Exchange Act, both in light of recent history and the specific statutory requirement that the agencies adopt risk retention standards for CDOs, and similar instruments collateralized by asset-backed securities.[240] The comments received in response to the reproposal did not raise any issues to cause the agencies to expand the scope of the exemptions for resecuritizations. In particular, the agencies do not believe that suggestions for distinguishing ''typical'' resecuritizations from CDOs or other higher risk transactions could be applied consistently across transactions.

As a consequence, the agencies are adopting the pass-through resecuritization exemption in section 19(b)(5), as proposed in the reproposal. This exemption will apply only if the resulting resecuritization ABS interests consist of only a single class of interests and provides for a pass through of all principal and interest payments received on the underlying ABS interests (net of expenses of the issuing entity). The new ABS interests have to be collateralized solely by servicing assets and existing ABS interests issued in a securitization transaction for which credit risk was retained as required under the rule, or which are otherwise exempted from credit risk retention requirements in the rule.

The agencies are also adopting as proposed the exemption in section 19(b)(6). Thus, to qualify for this exemption, the ABS interests issued in the resecuritization must share pro rata in any realized principal losses with all other holders of ABS interests issued in the resecuritization based on the unpaid principal balance of such interest at the time the loss is realized. The transaction must be structured to reallocate prepayment risk, and cannot re-allocate credit risk (other than credit risk reallocated as a collateral consequence of reallocating prepayment risk). While the agencies specifically invited comment on whether the issuance of an inverse floater as part of a first-pay class resecuritization exemption would be necessary to provide adequate prepayment protection for investors, the agencies received no specific response to this question or comments on the prohibition proposed on the issuance of an inverse floater or any similarly structured class of ABS interests as part of an exempt transaction under section 19(b)(6), and are adopting this prohibition as part of the final rule.

H. Other Exemptions From Risk Retention Requirements

1. Legacy Loan Securitizations

Some commenters on the original proposal recommended an exemption from risk retention for securitizations and resecuritizations of loans made before the applicable effective date of the final rule, or ''legacy loans,'' asserting that risk retention would not affect the underwriting standards used to create those loans. After considering the comments received on the original proposal, the agencies did not propose to provide an exemption from risk retention for legacy loan securitizations in the reproposal. The agencies did not believe that such securitizations should be exempt from risk retention, because risk retention requirements are designed to incentivize securitizers to select well-underwritten loans, regardless of when those loans were underwritten. Furthermore, the agencies did not believe that exempting securitizations of legacy loans from risk retention would satisfy the statutory criteria for an exemption under section 15G(e) of the Exchange Act.[241]

On the reproposal, the agencies received comments from one financial trade organization that again recommended exempting securitizations of legacy loans. This commenter requested that the agencies provide a legacy loan exemption, because in the case of loans that were originated prior to the adoption of the final risk retention rules, it would not have been possible to create those assets in compliance with a regulatory scheme whose precise terms were unknown at the time of origination.

As the agencies stated in the reproposal, the agencies do not believe it is appropriate to exempt legacy loans because the risk retention requirements affect the quality of loans that are selected for a securitization transaction. Therefore, the agencies are not adopting an exemption from risk retention for legacy loan securitizations in the final rule.

2. Corporate Debt Repackagings

Some commenters on the reproposal urged the agencies to adopt an exemption from risk retention for ''corporate debt repackagings.''[242] One

[238] Section 15G of the Exchange Act would not apply to asset-backed securities issued before the applicable effective date of the agencies' final rule, and that as a practical matter, private-label asset-backed securities issued before the applicable effective date of the final rule would typically not be compliant ABS interests. Asset-backed securities issued before the applicable effective date that meet the terms of an exemption from the rule or that are guaranteed by the Enterprises, however, could qualify as compliant ABS interests.

[239] *See* 15 U.S.C. 78o–11(a).

[240] *See* 15 U.S.C. 78o–11(c)(1)(F).

[241] *See* 15 U.S.C. 78o–11(e).

[242] According to commenters, corporate debt repackagings are created by the deposit of corporate debt securities purchased by the sponsoring

Continued

of these commenters recommended that, as an alternative, the agencies create a limited exemption for corporate debt repackaging transactions that repackage securities that could be sold directly to investors without risk retention, and that do not involve credit tranching. This commenter also proposed additional means of satisfying the risk retention requirements in corporate debt repackaging transactions, including the retention of 5 percent of the underlying securities in the repackaging transaction, or the retention of 5 percent of any class of securities issued in the repackaging that is *pari passu* with the securities being issued to the investors in the transaction.

Consistent with the reproposal and for the reasons discussed therein,[243] the agencies are not adopting an exemption for corporate debt repackagings. As stated in the reproposal, the agencies do not believe an exemption is warranted because the underlying assets (the corporate bonds) are not asset-backed securities. As the agencies stated in the reproposal, regardless of the level of credit risk a corporate debt issuer believes it holds on its underlying corporate bonds, the risk retention requirement would apply at the securitization level, and the sponsor of the securitization should be required to hold 5 percent of the credit risk of the securitization transaction. The agencies continue to believe that risk retention at the securitization level for corporate debt repackagings is necessary in order to align the interest of the sponsor in selecting the bonds in the pool and structuring the terms of the ABS interests with the interests of the investors in the securitization.

One commenter requested a general exemption for securitization transactions in which collateral consists primarily of unsecured direct obligations of the sponsor or its affiliates. The agencies are not adopting any such exemption as this commenter did not provide sufficient detail on which to base such exemption.

3. Securitizations of Servicer Advance Receivables

Some commenters requested that the agencies provide an exemption for servicer advance receivables.[244] According to these commenters, the servicer advance facilities (''SAFs'') pursuant to which these servicer advance receivables are securitized create the requisite levels of credit enhancement through over-collateralization in the form of an equity interest in the issuing entity, that is subordinated to all other classes of ABS interests issued by the issuing entity. These commenters indicated that securitizations of servicer advance receivables should be exempted from the risk retention requirements because servicer advances are payments that a servicer is required to make under the terms of the servicing agreements, and are not originated for purposes of distribution in a securitization transaction. These commenters also said that the fundamental goal of risk retention—the alignment of interests in order to produce higher quality underwriting standards—is not relevant in these servicer advance receivable securitizations, because these servicer advance receivables do not represent an extension of credit by a lender to a borrower, and that there is no underwriting criteria.

If the agencies declined to provide an exemption, these commenters requested that the agencies allow the equity interests held by servicer-sponsors of the SAFs to satisfy the risk retention requirement, and to allow the equity interest (in an SAF structured as a revolving master trust) that supports all series of ABS interests to qualify as a risk retention option for revolving master trusts.

The agencies are not adopting an exemption from risk retention for SAFs. The agencies believe that there is insufficient data to justify granting this specific exemption. Furthermore, the agencies do not believe that there are particular features of this type of securitization that would warrant an exemption under the factors that the agencies must consider in section 15G(e) of the Exchange Act. However, as discussed in Part III.B.2 of this Supplementary Information, an SAF that meets the final rule's eligibility requirements for the seller's interest option for revolving pool securitizations may avail itself of that option. Alternately, the sponsor of an SAF may structure its equity interest in the trust as an eligible horizontal residual interest.

V. Reduced Risk Retention Requirements and Underwriting Standards for ABS Interests Collateralized by Qualifying Commercial, Commercial Real Estate, or Automobile Loans

As contemplated by section 15G of the Exchange Act, the reproposal included a zero risk retention requirement, or exemption, for securitizations consisting solely of commercial loans, commercial real estate (CRE) loans, and automobile loans that met specific proposed underwriting standards (qualifying assets). The reproposal also would have allowed sponsors to commingle qualifying and non-qualifying assets of a similar type to receive up to a 50 percent reduction in the minimum required risk retention amount.

While many commenters supported the ability to blend pools of qualifying and non-qualifying assets to obtain a reduced risk retention amount, commenters also requested that the agencies reduce or remove the 50 percent limit on the reduction for blended pools of commercial, CRE, or automobile loans. Some commenters claimed that the limit would be a disincentive for sponsors to include more qualifying assets in blended pools (and thereby improve the overall quality of the pool) once the 50 percent threshold had been reached. In addition, a comment was made that, because the agencies would be imposing a risk retention requirement on qualifying assets if they exceeded 50 percent of the pool, this would be contrary to the overall proposed exemption for qualifying assets. Other commenters supported the limit on blended pools or generally opposed allowing blended pools of qualifying and non-qualifying assets because of the concern that a blended pool could facilitate the ability of sponsors to obscure the credit quality of the non-qualifying assets.

Under the reproposal, a sponsor of a transaction with a blended pool would have to provide disclosures to investors, its primary Federal regulator, and the Commission the manner in which the sponsor determined the aggregate risk retention requirement for the pool after including qualifying assets, a description of the qualifying and non-qualifying assets, and material difference between them. Furthermore, the reproposal would have required a sponsor to either repurchase out of the pool any qualifying asset found not to meet the proposed underwriting criteria after securitization or to cure the defects to bring the loan into conformity with the criteria. A few commenters

institution in the secondary market into a trust which issues certificates collateralized by cash flows on the underlying corporate debt securities.

[243] *See* Revised Proposal, 78 FR at 57975.

[244] According to this commenter, servicer advance receivables are contractual rights that entitle a servicer to reimbursement for advances that it is required, under the terms of the servicing agreements, to make for purposes of liquidity enhancement.

expressed concerns about the repurchase and certification requirements in the reproposal with respect to pools containing qualifying assets. A few commenters suggested that, because of liability concerns, sponsors should not be required to make the proposed disclosures about qualifying assets to investors. One of these commenters also claimed that the statutory language was drafted such that such certifications should only be applied to residential mortgages. The commenter further asserted that investors already receive sufficient information about underlying collateral in the other asset classes, such that the proposed disclosures and certifications would be an unnecessary burden, and that investors were additionally protected by the proposed buy back or cure requirement for assets found to be non-qualifying post securitization. The commenter also asked for clarification about how long a sponsor must maintain records related to the proposed disclosure and certification requirements. A commenter also requested that with respect to automobile loan securitizations that the proposed internal control certification requirements be allowed to be performed less frequently to reduce burden.

The final rule retains the 50 percent limit for blended pools for these three asset classes. The agencies are concerned that reducing the minimum risk retention for blended pools to less than 2.5 percent of the value of the ABS interests would significantly weaken the economic incentive for the sponsor to ensure that the non-qualifying loans in the pool are appropriately underwritten. However, the agencies are allowing a limited amount of blending, as proposed, to increase the liquidity of both qualifying and non-qualifying assets by allowing these assets to be securitized in the same pool.

The agencies are also adopting the disclosure and certification requirements with regard to securitizations including qualifying assets as proposed in the revised proposal. As discussed in the revised proposal,[245] the agencies believe that the disclosure and certification requirements are important to facilitating investors' ability to evaluate and monitor the overall credit quality of securitized collateral, especially where qualifying and non-qualifying assets are combined. The agencies believe that these transparency goals are essential to the integrity of the exemption from risk retention for qualifying assets. The agencies note that the record retention requirement for certification and disclosure in other parts of the rule is three years after all ABS interests are no longer outstanding.[246] The agencies are adopting the same standard for certification and disclosures with respect to the qualifying commercial, CRE, and automobile loan exemptions to remain consistent throughout the rule. The agencies believe this timeframe will allow for a sufficient period for review by the Commission or the sponsor's Federal banking agency, as appropriate.

The agencies note the concern expressed by some commenters with respect to all three of these asset classes that, for the residential mortgage asset class and QRM, a significant portion of the existing market would qualify for an exemption from risk retention, whereas in proposing the underwriting standards for qualifying commercial loans, commercial real estate loans, and automobile loans, the agencies proposed conservative underwriting criteria that would not capture an equivalent portion of the respective markets. The agencies observe that there is a homogeneity in the securitized residential mortgage loan market that does not exist for commercial loan or commercial real estate loan asset classes. Commercial loans and commercial real estate loans typically focus on a common set of borrower and collateral metrics, but they are individually underwritten and tailored to a specific borrower or property, and often contain terms developed in view not only of the borrower's financial position but also the general business cycle, industry business cycle, and standards for appropriate leverage in that industry sub-sector. The agencies believe the additional complexity needed to create underwriting standards for every major type of business in every economic cycle would be so great that originators would almost certainly be dissuaded from attempting to implement them or attempting to stay abreast of the numerous regulatory revisions the agencies would need to issue from time to time to keep up with the changing economic cycles or industries.

The reproposed underwriting standards established a single set of requirements, which are necessary to enable originators, sponsors, and investors to be certain as to whether any particular loan meets the rule's requirements for an exemption. For the agencies to expand the underwriting criteria in the fashion suggested by some commenters, the rule would need to accommodate numerous relative standards. The resulting uncertainty of market participants as to whether any particular loan was qualified for an exemption could undermine the market's willingness to rely on the exemption.

While there may be more homogeneity in the securitized automobile loan class, the agencies are concerned that attempting to accommodate a significantly large share of the current automobile loan securitization market would require weakening the underwriting standards to the point where the agencies are concerned that they would permit the inclusion of low quality loans. For example, the agencies note that current automobile lending practices often involves no or small down payments, financing in excess of the value of the automobile (which is itself an asset of quickly declining value) to accommodate taxes and fees, and a credit score in lieu of an analysis of the borrower's ability to repay. These concerns as to credit quality are evidenced by the high levels of credit support automobile securitization sponsors build into their securitization transactions, even for so-called ''prime'' automobile loans. Moreover, securitizers from the automobile sector who commented on the original proposal and reproposal expressed no interest in using any underwriting-based exemptive approach that did not incorporate the industry's current model, which relies almost exclusively on matrices of consumer credit scores, loan-to-value (LTV) ratios, and ''on the spot'' borrower approval. One commenter stated that the entire underwriting process must occur while the customer is at the dealership. As was discussed in the reproposal, the agencies are not persuaded that it would be appropriate for the underwriting-based exemptions under the rule to incorporate a credit score metric.[247]

Finally, commenters requested that the agencies clarify that the requirement that a depositor certify as to the effectiveness of its internal supervisory controls with respect to the process for ensuring that assets that collateralize the asset-backed securities are eligible for an exemption does not impose an obligation on sponsors to guarantee that all assets meet all of the requirements to be eligible for 0 percent risk retention. As is indicated by the final rule's provision of a buyback option for non-compliant assets, the agencies do not view the requirement as requiring that the controls guarantee compliance.

[245] Revised Proposal, 78 FR at 57986.

[246] Sections 4(d) and 5(j) of the final rule.

[247] Revised Proposal, 78 FR 57985.

Rather, the process must be robust and sufficient to enable the sponsor to carefully evaluate eligibility.

A. Qualifying Commercial Loans

The reproposal included definitions and underwriting standards for qualifying commercial loans (QCLs), that, when securitized, would be exempt from the risk retention requirements. The proposed definition of commercial loan generally would have included any loan for business purposes that was not a commercial real estate loan or one-to-four family residential real estate loan.

The proposed criteria for a QCL included determining compliance with the following financial tests based on two years of past data and two years of projections: a total liabilities ratio less than or equal to 50 percent; a leverage ratio [248] of less than or equal to 3.0x; a debt service coverage (DSC) ratio of greater than or equal to 1.5x. A QCL would need to base loan payments on a straight-line amortization schedule over no more than a 5-year term. Additional standards were proposed for QCLs that are collateralized, including lien perfection and collateral inspection standards.[249]

Commenters generally asserted the proposed criteria were too strict in one or more areas. One commenter claimed that the QCL exemption would have no relevance for securitizations of commercial loans because loans that would satisfy the proposed QCL criteria typically would not be securitized and that the agencies did not seriously attempt to consider the historical performance of the asset class. Some commenters also supported the submission by other commenters to allow syndicated loans meeting certain criteria, when held by CLOs meeting certain other structural criteria, to be exempt from risk retention, as discussed above in Part III.B.7 of this Supplementary Information.

Some commenters requested that the agencies create multiple types of QCL underwriting criteria to address different industries or different types of commercial loans, for example, establishing separate criteria for vehicle fleet loans or equipment loans in order to exempt loans meeting such criteria from risk retention. These commenters asserted that the securitizations of equipment loans have performed well before, during, and after the financial crisis and that such loans should therefore have their own asset class and underwriting criteria to qualify for an exemption.

Commenters also suggested that the agencies relax the proposed QCL standards in various ways, including by: Removing the straight-line amortization criterion; increasing the maximum amortization period beyond 5 years (up to 15 or 20 years); allowing payment-in-kind loans; reducing retention for debtor-in-possession situations and loans resulting from Chapter 11 exit financings; increasing the leverage ratio to 4.5 or less; and replacing the leverage ratio with a 60 percent or 50 percent debt-to-capitalization ratio. One commenter also urged the agencies to require a valuation such as a qualified appraisal for all collateralized QCLs, noting that other proposed criteria—such as requiring a perfected security interest for secured commercial loans—would be of limited utility without a valuation requirement.

For the subsequently discussed reasons, the agencies are adopting the QCL standards as proposed. While the agencies recognize that there are many types of commercial loans to serve many types of industries and companies, it would be impracticable to accommodate each category of loan and industry with a unique set of underwriting criteria. Even applying a different set of criteria to a broader category within commercial loans, such as equipment loans, would be under- and over-inclusive and could have unintended consequences for the alignment of interests of sponsors and investors. Furthermore, as the different industries and economic conditions in which they operate change over time, such regulatory underwriting criteria could influence originations in unintended ways. In developing the underwriting standards for the reproposal, the agencies intended for the standards to be reflective of very high quality loan characteristics for most commercial borrowers. To the extent that a commercial loan is securitized, the agencies believe that risk retention provides an appropriate incentive to sponsors to carefully consider the underwriting quality of the loans being securitized; therefore, only those commercial loans that are of very high quality should be exempt from risk retention. The agencies have concluded that the proposed high quality underwriting standards are appropriate for QCLs generally, even if the standards do not correspond to the profile of loans generally securitized in CLOs. While some commercial loans are structured as bullet or interest-only loans, the agencies determined that such loans are not appropriate for QCL given the deferral of principal repayment until maturity, which can overstate the borrower's repayment capacity as measured by the DSC ratio (due to a lack of principal payments) and increase default risk related to having to refinance a larger principal amount at maturity.

While commercial loans do exist with longer terms than the maximum permitted under the underwriting criteria, the agencies do not believe such long-term commercial loans are common, and they involve more uncertainty about continued repayment ability, particularly when loans are made without collateral. With respect to payment-in-kind loans, the agencies observe that these loans are generally riskier loans, as borrowers may not be paying any interest in cash over part or all of the loan term. Therefore, the agencies do not believe it is appropriate to incorporate the changes requested by commenters with respect to term and payment-in-kind in the QCL underwriting criteria.

The agencies also continue to favor the reproposed earnings-based leverage ratio, as opposed to a capitalization ratio, to measure the ability of a borrower to service the debt and thus help determine the consequent riskiness of a loan. Finally, while a commercial lender should consider the accuracy of valuation of collateral to the extent it is a factor in the repayment of the obligation, the agencies are declining to impose a requirement of a qualifying appraisal or other particular valuation for collateral securing a QCL. The agencies observe that many types of collateral could be pledged to secure a commercial loan and, therefore, mandating particular valuation methods could be very complex and unintentionally exclusive, thereby discouraging secured loans, which are frequently safer as credits than unsecured loans and therefore provide additional avenues for funding for many borrowers. Additionally, a valuation requirement would increase the burden associated with underwriting a QCL.

In addition to the underwriting criteria discussed above, in the reproposal, the agencies proposed that all QCLs must be funded prior to the securitization and that the securitization not allow for any reinvestment periods. In addition, if a loan was subsequently found not to have met the QCL criteria, the sponsor would have been required to effect a cure or buyback of the loan.

[248] Under the reproposal, the leverage ratio would have been defined as the borrower's total debt divided by the borrower's annual income of a business before expenses for interest, taxes, depreciation and amortization are deducted, as determined in accordance with GAAP. *See* section 14 of the revised proposal (definition of ''leverage ratio'').

[249] *See* Revised Proposal, 78 FR at 57979.

One commenter requested that the agencies allow QCL loans to be funded up to six months after the issuance of the securitization. Some commenters also requested that the agencies allow QCL securitizations to have reinvestment periods, so long as the new loans added to the pool would either be QCLs or not reduce the QCL/non-QCL blended pool ratio below 50 percent. Finally, some commenters opposed the buyback provision, noting that open market CLO managers designated as sponsors under the rule are thinly capitalized and generally would not have significant financial resources available to buy back loans in the pools they manage.

The agencies are not adopting these commenter suggestions in the final rule. The agencies believe that only funded loans should be recognized as QCLs for purposes of exemption from risk retention, as there could be an adverse change in circumstances between the closing date of the securitization and a subsequent funding date for the loan that could disadvantage investors. Furthermore, changes in circumstances could mean the loan may not meet the quantitative QCL requirements upon funding. The agencies also decline to allow reinvestment periods for securitizations including QCLs. As discussed herein and in the revised proposal, there are increased concerns about transparency when qualifying and non-qualifying assets are mixed in a pool and an exemption from risk retention applies to the qualifying assets. Allowing reinvestment in addition to allowing blending of qualified and non-qualified assets could exacerbate these concerns and could allow sponsors to increase the risk of an initial pool that had a significant portion of QCLs in ways that would be difficult for investors to discern post-closing. Finally, the agencies are not removing the buyback requirement where QCLs are subsequently found not to have met the underwriting criteria at origination. The agencies do not believe that lack of financial resources of the sponsor should excuse the sponsor from meeting its obligations to ensure a loan labelled a QCL at origination met the QCL requirements. In addition, the rule allows certain underwriting errors to be addressed through cure, which would not require repurchase of the entire loan out of the pool and thus could be less financially burdensome for the sponsor.

B. Qualifying Commercial Real Estate Loans

Both the original and the revised proposals included underwriting standards for CRE loans that would be exempt from risk retention if the loans met those standards (qualifying CRE loans, or QCRE loans). As discussed in the revised proposal, the agencies made a number of changes to the QCRE standard in the reproposal to address concerns raised by commenters with respect to the original proposal. The proposed standards focused predominantly on the following criteria: The borrower's capacity to repay the loan; the value of, and the originator's security interest in, the collateral; the LTV ratio; and, whether the loan documentation includes the appropriate covenants to protect the value of the collateral.

1. Definition of Commercial Real Estate Loan

In the reproposal, a CRE loan would have been defined as any loan secured by a property of five or more residential units or by non-residential real property, where the primary source of repayment would come from the proceeds of sale or refinancing of the property or underlying rental income from entities not affiliated with the borrower. The definition would have specifically excluded land loans.

Some commenters questioned the exclusion of certain land loans from the definition of CRE in the original and revised proposals. Specifically, these commenters stated that numerous CMBS securitizations include loans to owners of a fee interest in land that is ground leased to a third party who owns the improvements and whose ground lease payments are a source of income for debt service payments on the loan. These commenters suggested that the agencies clarify that the exclusion did not apply to such loans, because these loans are included in many existing CMBS securitizations and the entire securitization would be unable to use CMBS risk retention option due to these loans being excluded from the CRE definition.

As explained in the revised proposal, the agencies did not take commenters suggestion to include some land loans in the definition of commercial real estate because of concerns, among other things, that separation of ownership between land and buildings could complicate servicing and foreclosure.[250] However, having carefully considered comments on this point following the reproposal, the agencies have decided to modify the definition of commercial real estate in the final rule to address commenters' concerns about these land loans. The agencies have concluded that excluding these ground-leased land loans on improved property from the definition is not warranted and so have explicitly included them in the definition of commercial real estate so that these loans may qualify as QCRE loans if they otherwise meet the qualifying criteria, or alternatively, may be included with pools of other CRE loans to allow the sponsor to use the third-party purchaser form of risk retention discussed in Part III.B.5 of this Supplementary Information.

2. Single Borrower Underwriting Standard

Commenters generally supported the reproposed exemption from risk retention for QCRE loans. However, as discussed further below, many commenters stated that the proposed underwriting criteria were too strict and requested that the agencies modify the QCRE loan criteria to allow more loans to qualify for the exemption. In addition, some commenters requested that the agencies expand the QCRE loan criteria for, or provide an additional QCRE loan exemption for, single-borrower or single-credit (SBSC) transactions involving a securitization of cross-collateralized loans provided to one or more related borrowers. Commenters stated that these transactions warranted an exemption because they typically have had stronger historical performance than non-SBSC CMBS transactions and due to market practice, few or none would qualify as a QCRE loan. In addition, commenters asserted that B-piece buyers have not historically been involved in these transactions because of the limited number of loans involved. Commenters also asserted that these transactions are particularly transparent to investors because they involved only a few, large loans (as compared to other CMBS transactions) and investors typically receive granular information with respect to the loans. Commenters asserted that risk retention for these structures would cause costs to increase and possibly reduce access to credit for some companies without a commensurate increase in investor protection, given the nature of the loans involved and transparency to investors. One commenter proposed that the SBSC exemption rely exclusively on extensive disclosure about the securitization structure and loans in the structure rather than quantitative underwriting criteria. Commenters also proposed that only larger SBSC deals (over $200 million in ABS interests issued) be exempted from risk retention to reduce the possibility that the exemption would be used to effectively exempt a significant section of the market.

[250] *See* Revised Proposal, 78 FR at 57980.

The agencies have carefully considered the commenters' requests for separate QCRE loan criteria for SBSC transactions. Having reviewed information provided by commenters as well as other information related to this market, the agencies have concluded that it would not be appropriate to adopt separate QCRE loan underwriting criteria for SBSC transactions. An SBSC transaction may qualify for an exemption from risk retention, like other CMBS transactions, to the extent the securitized loans qualify as QCRE loans, and the regulators do not believe there is sufficient support to justify establishing separate underwriting criteria for SBSC transactions. The agencies have not concluded that SBSC transactions as a category are of sufficiently low risk to warrant a special exemption from risk retention. While most CMBS transactions involve diversifying risk across types of properties, SBSC transactions generally focus on one specific type of property (for example, loans on properties related to one brand of hotel), which potentially concentrates and increases credit risk as compared with a diversified CMBS securitization. In addition, because of the cross-collateralization or cross-default provisions in these deals and the reliance on a single borrower, the failure of one loan in a deal could cause a default of the entire securitization.

Furthermore, the agencies are concerned that it would be difficult to construct a definition that captures an SBSC transaction in a way that would address the commenters' concerns while also being sufficiently limited in scope to prevent widespread use of the option in a manner that would undermine consistent application of the rule for CMBS transactions. The agencies are further concerned that using a deal size threshold to reduce inappropriate use of the option could be unnecessarily arbitrary and restrictive for smaller borrowers without providing sufficient regulatory benefit. Additionally, the agencies are concerned that such a definition would inadvertently lead to exempting from risk retention CMBS transactions with lower quality underwriting than intended by the exemption and less stringent cross-collateralization or cross-default features, as well as other criteria historically associated with SBSC transactions.

In addition, the agencies have concerns that the commenters' suggested conditions for which transactions would qualify as a single-borrower transaction or as a single-credit transaction would allow for widespread structural evasion of the rule. A sponsor could easily structure a CMBS transaction in which the single asset is a mortgage loan secured by multiple properties or in which the single borrower is an SPV formed by an entity that wants to finance a portfolio of unrelated properties.

Finally, the agencies note, as discussed further below, that the criteria for QCRE loans has been modified in the final rule to provide some additional flexibility.

3. Proposed QCRE Loan Criteria

As discussed above, the agencies adjusted some of the QCRE loan underwriting criteria as set forth in the original proposal in response to commenter concerns. The agencies generally reproposed the original structure of the qualifying criteria, divided into four categories: ability to repay, loan-to-value requirement, valuation of the collateral, and risk management and monitoring. These sections and their associated comments are discussed below.

The agencies received some comments that were generally supportive of the QCRE loan criteria in the reproposal and that requested that the agencies not loosen the criteria further because of concerns of the effect that could have on lender behavior, to the detriment of investors in CMBS transactions. One commenter in particular supported the collateral valuation requirements with respect to appraisers.

A number of commenters said the QCRE loan criteria were generally too conservative, noting that only a small number of commercial real estate loans would meet the criteria and that the exemption from risk retention for QCRE loans would be rendered impractical for most sponsors, thereby eliminating incentives to originate QCRE loans and possibly causing funding problems, including for multifamily loans if the Enterprises were to stop providing funding. One commenter claimed that because the QCRE loan criteria is narrow and many CMBS transactions would be subject to risk retention, this could cause rents to rise in the multifamily sector and slow down job creation.

Some commenters asserted that a much lower percentage of commercial real estate loans would qualify as QCRE loans than residential mortgages would qualify as QRMs under the reproposal, and generally recommended that the QCRE loan criteria be crafted to capture a portion of the market similar to that portion of the residential mortgage market captured by the QRM definition. Another commenter suggested that the agencies modify the QCRE loan criteria to follow metrics ''more typical'' of balance sheet lenders such as insurance companies and commercial banks. Another commenter asserted that the proposed QCRE loan criteria would introduce interest rate sensitivity into the CMBS market where it does not currently exist. A few commenters requested that the agencies consider distinct QCRE loan underwriting standards for different commercial real estate sectors. For example, a commenter urged the agencies to allow for a higher loan-to-value ratio for multifamily loans than allowed under the reproposed QCRE loan criteria.

Many of the commenters who generally opposed the proposed QCRE loan definition had specific critiques or suggestions related to each of the categories of QCRE loan criteria, as discussed below.

4. Ability To Repay Criteria and Term

Like the original proposal, the reproposal included a number of criteria that would relate to the borrower's ability to repay in order for a loan to qualify as a QCRE loan. The borrower would have been required to have a DSC ratio of at least 1.25x for qualifying multi-family property loans,[251] 1.5x for qualifying leased QCRE loans,[252] and 1.7x for all other commercial real estate loans. The reproposed standards also would have required reviewing two years of historical financial data and two years of prospective financial data of the borrower. The loan would have been required to have either a fixed interest rate or a floating rate that was effectively fixed under a related swap agreement. The loan documents also would have had to prohibit any deferral of principal or interest payments and any interest reserve fund, resulting in excluding interest-only loans from qualifying as QCRE loans.

The reproposal included a maximum amortization period of 25 years for most commercial real estate loans, and 30 years for qualifying multi-family loans, with payments made at least monthly for at least 10 years of the loan's term. Furthermore, payments made under the

[251] Under the reproposal, a ''qualifying multi-family loan'' would be, generally, a commercial real estate loan secured a residential property with five or more residential dwellings and where at least 75 percent of the net operating income is derived from residential units and tenant amenities, but not other uses. *See* Revised Proposal, 78 FR at 58038.

[252] Under the reproposal, a qualifying leased commercial real estate loan generally means a commercial real estate loan secured by nonfarm real property (other than multi-family and hotel properties) that is occupied by tenants meeting certain criteria. *See* Revised Proposal, 78 FR at 58038.

loan agreement would be required to be based on a straight-line amortization of principal and interest over the amortization period (up to the maximum allowed amortization period, noted above). The minimum loan term could be no less than 10 years and no deferral of repayment of principal or interest could be permitted.

A number of commenters objected to the agencies' reproposed DSC ratios as too conservative, or suggested eliminating or changing the DSC ratio criteria. Some commenters suggested lowering qualifying DSC ratios to a range between 1.25x and 1.5x, or establishing criteria similar to those used by Fannie Mae or Freddie Mac to fund multifamily real estate loans. However, a commenter expressed concern that the reproposed QCRE loan criteria unduly loosened the standard and supported increasing the DSC ratio to 2.4x. A commenter claimed that the DSC and LTV criteria, without taking into consideration other characteristics of a property, would lead to an inappropriate assessment of risk, and that each commercial real estate property has a unique risk profile.

Some commenters supported removing the proposed requirement to examine two years of past borrower data or replacing it with two years of property data, as they stated that many new CRE loans involve stabilized properties purchased by new SPVs and the SPVs would not have two years of historical data. In addition, as these loans are generally non-recourse (or are made to SPVs whose only asset is the subject real estate), only the property and income stream from the property are available to satisfy the loan obligation.

Many commenters supported the requirement for fixed interest rate loans for QCRE loans. However, some commenters suggested expanding the types of derivatives allowed to convert a floating rate into a fixed rate through a rate cap derivative. Some commenters also supported the restrictions on deferrals of principal and interest. However, other commenters supported allowing interest-only loans if those loans had a lower LTV ratio (such at 50 percent).

Many commenters objected to the minimum length and amortization of QCRE loans. These commenters said that 3, 5, and 7-year CRE loans have become common in the industry, and therefore asserted that the proposed minimum 10-year term criterion would inappropriately disqualify numerous loans without much regulatory benefit. A commenter asserted, for example, that default and delinquency data demonstrates that loan term does not materially factor into or increase the likelihood of loss for CMBS investors. Another commenter asserted that the loss rate for shorter term loans is better than for 10-year loans. For similar reasons, these commenters also supported a longer amortization period for QCRE loans, up to 30 years. Other commenters, however, requested that the agencies continue to disqualify interest-only loans from QCRE loans and also to maintain the minimum term at 10 years.

After carefully considering the comments on the underwriting criteria for QCRE loans, the agencies are adopting in the final rule QCRE loan criteria similar to those in the reproposal, with some modifications to address some commenter concerns. The agencies are not changing the DSC ratios from the reproposal, because the agencies believe reducing these requirements would inappropriately allow riskier loans to qualify for a complete exemption from risk retention. As noted in the reproposal, these criteria are consistent with the Federal banking agencies' historical standards for conservative CRE lending.[253]

The agencies are also retaining the requirement not to include interest-only loans or loans with interest-only periods as QCRE loans. The agencies believe that interest-only loans or interest-only periods distort assessment of repayment ability, increase risk at maturity due to lack of principal reduction, and may present increased credit risk, even with a lower LTV ratio and, accordingly, would be inappropriate for qualifying CRE loan treatment.

With respect to maximum amortization periods, the agencies are aware that there are many non-multifamily CRE loans with amortization periods in excess of 25 years. However, allowing a longer amortization period for these loans reduces the amount of principal paid each month on the loan before maturity, which can increase risks related to having to refinance a larger principal amount than would be the case for a loan with a shorter amortization period. Because the agencies believe that loans with a maximum 25-year maturity reflect more stringent underwriting, and believe that exemptions from risk retention should be available only for the most prudently underwritten CRE loans, the agencies are adopting an amortization period of 30 years for multifamily residential QCRE loans and 25 years for all other QCRE loans. The agencies are also making a technical change from requiring straight-line amortizing payments to level payments of principal and interest.

The agencies are also adopting a 10-year minimum maturity for QCRE loans. The agencies believe that loans with terms shorter than 10 years, such as three, five, or seven years, may create underwriting incentives not commensurate with the high credit quality and low risk necessary for a loan to qualify as a QCRE loan. For example, when making a shorter term loan, an originator may focus only on a short timeframe in evaluating the stability of the real estate underlying the loan in an industry that might be at or near the peak of its business cycle. In contrast, a 10-year maturity CRE loan requires underwriting through a longer business cycle for the property, including downturns that may not be captured appropriately when underwriting to a shorter time horizon.

In response to comments on lack of data availability for new loans to SPVs that recently purchased property, the agencies are making modest adjustments to the QCRE loan criteria to facilitate loans to such borrowers. Therefore, the final rule allows originators to use two years of historical data from the property, when the property has two years of operating history.[254] Under this revised standard, properties with less than two years of operating history would still be excluded from the QCRE loan standards because new properties present significant additional risks and loans on those properties generally should not be exempt from risk retention.

Similar to the reproposal, the final rule requires that the interest rate on a QCRE loan be fixed or convertible into a fixed rate using a derivative product. However, in the final rule, the agencies have expanded the allowable derivatives to include interest rate cap derivatives, provided that the loan is underwritten based on the maximum interest rate allowable under the cap, even if the loan is originated at a lower rate. The agencies are not proposing to allow other types of derivatives because they have concluded they are insufficiently transparent for a QCRE loan standard.

5. Loan-to-Value Requirement

The revised proposal would have required that the combined loan-to-

[253] These standards include the ''Interagency Guidelines for Real Estate Lending.'' 12 CFR part 34, subpart D, Appendix A (OCC); 12 CFR part 208, subpart C, Appendix A (FRB); 12 CFR part 365, Appendix A (FDIC).

[254] In the CRE lending context, a sponsor is the party that ultimately controls the property, such as by owning an SPV, which in turn owns the CRE.

value (CLTV) ratio for first and junior loans for QCRE loans be less than or equal to 70 percent and the LTV ratio for the first-lien loan be less than or equal to 65 percent; or that the CLTV and LTV ratios be less than or equal to 65 and 60 percent, respectively, for loans with valuation using a capitalization rate below a certain threshold, as set forth in the reproposal.[255] As discussed in the reproposal, the agencies concluded that these criteria would be appropriate for high quality commercial real estate loans and to help protect securitization investors against losses from declining property values and potential defaults on the CRE loans.[256]

Many commenters recognized that LTV standards are important to ensuring high quality CRE loan underwriting. While some commenters supported the agencies' proposed ratios, others asserted that they were too conservative. Some commenters suggested that higher LTV ratios (generally up to 70 percent) should be allowed in the QCRE loan standards, that the CLTV ratio cap be removed, and that the reduction in LTV and CLTV ratios for loans with certain valuation assumptions be removed. Others, however, suggested more conservative maximum LTV ratio criteria, including a 50 percent LTV ratio suggestion for interest-only loans, if they were to be permitted in the QCRE loan criteria by the agencies. One commenter indicated that the highest quality loans secured in CMBS tended to have lower LTV ratios than would be permitted for the QCRE loan standard, and expressed concern that the agencies may not have been conservative enough in the reproposal.

The agencies have considered the comments on LTV and CLTV ratio requirements for QCRE loans and are adopting the standards as reproposed. The agencies agree with those commenters who generally supported a 65 percent LTV ratio requirement. While the agencies are not adopting a 70 percent LTV ratio requirement, the 65 percent LTV ratio requirement still allows for 70 percent debt financing with up to 5 percent subordinated financing. As discussed in the reproposal, the agencies observe that the more equity a borrower has in a CRE project, the lower the lender or investor's exposure to credit risk and the greater the incentive for the borrower to perform on the loan. Overreliance on excessive subordinated financing instead of equity financing for a CRE property (which increases CLTV ratios) can significantly reduce the cash flow available to the property, as investors in subordinated finance often require high rates of return to offset the increased risk of their subordinate position. The agencies have concluded that a 70 percent CLTV ratio cap is generally appropriate for a low risk QCRE loan standard, which would require the borrower to have at least 30 percent equity in the project to help protect securitization investors against losses from declining property values and potential defaults.

The agencies decline the commenters' suggestion to reduce the maximum LTV ratio requirement for all QCRE loans, as 65 percent is sufficiently conservative for a QCRE loan standard given the other conservative underwriting requirements in the rule. The agencies also decline to adopt a 50 or 55 percent LTV ratio requirement for interest-only loans. As discussed above, the agencies believe interest-only loans, even at lower LTV ratios, present significant risks that would not meet an appropriately conservative QCRE loan underwriting standard.

The agencies are also retaining the requirement that the maximum LTV and CLTV ratios be lowered by 5 percent under certain appraisal conditions, as in the reproposal, with minor technical modifications to address commenter concerns. The ratios are only reduced if the appraisal used to qualify the CRE loan as a QCRE loan used an income approach with a direct capitalization rate, and that rate was lower than the rate permitted by the final rule. The final rule text clarifies that the appraisal used to qualify the CRE loan is not required to use a direct capitalization rate. Generally, as direct capitalization rates decline, values increase. In a lower cap rate environment there is an increase in the amount that can be borrowed given a fixed LTV or CLTV ratio, which is why the lower LTV and CLTV ratios would apply. In addition, to address concerns about appraisals using excessively high cap rates, the agencies are requiring that if a direct capitalization rate was used in an appraisal to qualify the loan as a QCRE loan, the rate must be disclosed to investors in the securitizations.

6. Collateral

The agencies proposed to require an appraisal and environmental risk assessment for every property serving as collateral for a QCRE loan. Commenters strongly supported both the appraisal and environmental risk assessment for all QCRE loan properties. Many commenters indicated this is already standard industry practice. A few commenters expressed the view that the agencies were too strict in requiring specific types of appraisals, such as an income-based appraisal using a discounted cash flow and an appraisal using a direct capitalization rate, rather than allowing a certified appraiser to determine the appropriate valuation method. As noted above, the agencies have made clarifications in the final rule to provide originators and appraisers with more flexibility in determining the appropriate appraisal approaches for a specific property that would be used to meet the QCRE loan standards, while not restricting appraisers from using other valuation methods that they believe are appropriate for the property. The agencies also made a technical change in the final rule to reflect the common appraisal terminology and Uniform Standards of Professional Appraisal Practice terminology for the income approach that is required to be in the written appraisal.

7. Risk Management and Monitoring

The reproposal would have required lenders to obtain a first lien in the property and limited the ability to pledge the property as collateral for other loans. While many commenters supported the first-lien requirement, one commenter supported allowing unlimited junior liens to finance energy-efficient improvements on the CRE property subject to the loan. A commenter requested that the agencies modify the proposed QCRE loan criteria to take into account *pari passu* and junior lien loans, noting that such modifications would not increase the risk of QCRE loans. Some commenters supported the requirement that a borrower obtain insurance on the property up to the property value, while other commenters requested that the requirement be changed to require insurance up to the lesser of the replacement cost of the property improvements or the loan balance.

The agencies are adopting the lien requirements as proposed. While energy-efficient improvements may reduce utility expenses associated with the property, the agencies do not wish the rule to facilitate structures whereby additional financing, even if subordinate, is obtained and thus increases leverage on the property. Regarding the insurance amount, the agencies have concluded that a strong QCRE loan standard would be maintained if the insurance limit in the criteria was changed to no less than the replacement cost of property improvements, in accordance with more customary market practice. After reviewing the related comment, the

[255] Revised Proposal, 78 FR at 58041.

[256] Revised Proposal, 78 FR at 57982.

agencies determined that loan balance was not an appropriate measurement as, in some jurisdictions, a lender may be required to make insurance proceeds available to a borrower and, in those circumstances, a prudent lender would wish to make sure that the proceeds are sufficient to fully repair or replace the insured property.

C. Qualifying Automobile Loans

Similar to the original proposal, the revised proposal included underwriting standards for automobile loans that would be individually exempt from risk retention (qualifying automobile loans, or QALs) if securitized. As in the original proposal, the definition of automobile loan in the reproposal generally would have included only first-lien loans on light passenger vehicles employed for personal use. It specifically excluded loans for vehicles for business use, medium or heavy vehicles (such as commercial trucks and vans), lease financing, fleet sales, and recreational vehicles including motorcycles. As explained in the reproposal, the agencies did not follow recommendations to propose including loans on vehicles more frequently used for recreational purposes, such as motorcycles or business purposes, because the risks and underwriting of those loans would be different than that for vehicles used for personal use. In addition, the reproposed definition did not include automobile leases because, as the agencies explained, leases represent a different set of risks to securitization investors than purchase loans. For example, automobile resale price at the end of the lease period can affect the securitization cash flow, which is not the case for purchase loan securitizations.[257]

While some commenters supported the reproposed definition of automobile loan, others asserted that it continued to be too narrow. Several commenters suggested expanding the definition to include motorcycles, because often they are not used solely as recreational vehicles but as primary transportation and because, as these commenters asserted, motorcycle loans perform as well as auto loans. The commenters asserted that there would be no reason to categorically exclude motorcycles from the QAL definition, even if they could otherwise meet the QAL criteria, by excluding motorcycles from the definition of automobile loan. They also contended that the fact some motorcycles are used for recreational use does not lead to adverse motorcycle loan performance.

Other commenters supported allowing automobile leases to qualify as QALs and recommended certain technical changes to the proposed QAL criteria. In particular, one commenter supported expanding the definition to include fleet purchases or fleet leasing, on the basis that these leases or sales are generally with corporations or government entities with strong repayment histories.

Another comment on the definition of automobile loan raised concerns that it would be difficult for an originator to determine whether an automobile purchase was for consumer or non-consumer use.

The agencies have carefully considered these comments and are adopting the definition of automobile loans for QAL underwriting standards as reproposed. The agencies believe it continues to be appropriate to restrict the definition of automobile loan to light passenger vehicles employed for personal use, not including motorcycles and other vehicles that are commonly used for recreational purposes, as well as everyday personal transportation. While the agencies acknowledge some motorcycle loans may have strong underwriting and risk characteristics similar to those of automobile loans, the agencies have concluded that overall risk profile of motorcycles as a class remains distinct from that of automobiles and, like other recreational vehicles, exhibit overall a higher risk profile. Certain recreational vehicles may also be highly customized before or after purchase, which may reduce resale or recovery value in case of borrower default.

The agencies also have decided not to expand the definition of automobile loan to include vehicles used for business purposes through fleet loans, as the risks and underwriting of such loans differ from those of vehicles used for personal transportation. For example, a car or truck used in a business may endure significantly more wear and depreciate much faster than a vehicle used only for normal household use.

Similarly, for the reasons discussed in the reproposal, the agencies are not expanding the definition of automobile loan to include automobile leases. The agencies remain concerned that the credit risks posed by leases are different than automobile purchase loans, in part (as discussed above) due to resale price risk associated with returned vehicles.

Regarding the comment on difficulties determining consumer purpose, the agencies believe originators or dealers will be able to differentiate between types of customers based on the existing process dealers and lenders must use to comply with TILA, which requires disclosures be provided to borrowers purchasing vehicles for personal use.

The QAL underwriting criteria in the reproposal included requirements regarding a borrower's ability to repay an automobile loan, including with respect to verification of borrower income and a borrower debt-to-income (DTI) ratio of no more than 36 percent. The loan term criteria included a first lien security interest on the vehicle, maximum maturity date, fixed rate interest, and level monthly payments with full amortization of the loan, as well as strict limits on deferral of payments and deferral of initiation of payments. The credit history criteria included verification and minimum credit history standards (such as no bankruptcy or repossession within the previous 3 years). The LTV criteria impose a borrower down payment requirement equal to fees, warranties and 10 percent of the purchase price.[258]

The agencies received a number of comments on the proposed QAL underwriting criteria. Generally the comments expressed concern that very few automobile loans would meet the QAL criteria because they would not fit existing market practices. Some commenters asserted that because the QAL criteria would not be met in existing market practice, the resulting risk retention requirements on automobile securitizations could discourage new issuances and impede liquidity and consumer credit. Others asserted this result would be unduly punitive to automobile securitizations as strong performers during the crisis, especially as compared to the proposed definition of QRM, which would exempt most residential mortgages from risk retention. Some commenters also offered particular suggestions to change the criteria, as discussed further below with respect to each category of criteria. Additionally, some commenters requested that the agencies apply the quantitative portions of the underwriting standards on a pool basis (which would assess underwriting standards on a pool-wide, rather than loan by loan, basis) rather than to individual loans, noting that the homogeneity of securitized automobile loans and their typical characteristics (not subject to interest rate fluctuations or refinancings) would make an exemption from risk retention based on pool level criteria appropriate. The agencies are not adopting this suggestion in the final rule and the final rule only permits the exemption to

[257] See Revised Proposal, 78 FR at 57983.

[258] See Revised Proposal, 78 FR at 57984–57985.

apply to individual loans that meet the QAL criteria. The agencies observe that section 15G of the Exchange Act indicates that the reduction from risk retention for a qualifying asset is limited to the asset itself that is securitized, and does not suggest an exemption for a pool of assets that meets pool-wide underwriting criteria.[259] Accordingly, the final rule provides that the underwriting standards for QAL must be met by each loan for that loan to be exempt from risk retention. Furthermore, the agencies do not believe providing risk retention on a pool basis would further the goals of risk retention and could lead to some of the transparency concerns discussed with respect to unlimited blending of non-qualifying assets with qualifying assets. For example, an exemption based on pool-level underwriting criteria could obscure the true credit quality of the pool in a way that would be difficult for investors to discern because of the potential for wide variation (and varying degrees of document verification) of the underwriting quality of those assets in a pool that did not meet a QAL standard on an individual basis.

1. Ability To Repay Criteria

As noted above, the ability-to-repay criteria for QALs in the reproposal included a DTI ratio not in excess of 36 percent of a borrower's monthly gross income. Under the proposed QAL criteria, originators would also have been required to verify a borrower's income and debt payments using standard methods.

Commenters generally disagreed with the proposed ability-to-repay criteria and requested a higher maximum DTI ratio or elimination of the ratio criterion, on the basis that it is not typically used in current automobile loan underwriting and not using it has not adversely affected automobile loan performance because (commenters claimed) borrowers often prioritize payment of their automobile loans over other debt obligations. Some commenters offered a number of suggested adjustments to the proposed DTI and verification requirements. Other commenters suggested using a payment-to-income (PTI) ratio instead of a DTI ratio because, they claimed, a PTI ratio is a stronger predictor of vehicle loan performance than a DTI ratio and does not involve as many operational burdens as a DTI ratio in providing quick approval of automobile loans, a practice expected by automobile consumers. A commenter also asserted that the proposed DTI requirements would put lenders that rely on the securitization markets for funding at a disadvantage to lenders that do not. Regarding the verification requirements, commenters suggested that if verification of debt and income would be retained as a criterion, originators should only be required to verify those debts listed on a borrower's credit report and rely on borrower stated income without verification.

The agencies have carefully considered these comments, but have concluded that the reproposed DTI criteria, including verification requirements, is essential to determining a borrower's ability to repay, which in turn is essential to a strong consumer underwriting standard. As discussed in the original and revised proposals, the agencies believe that a total exemption from risk retention should be applied only to those loans that meet underwriting criteria associated with strong credit performance. A DTI ratio is a meaningful and comprehensive method for calculating a borrower's ability to repay a loan, while a PTI ratio does not include other potentially significant debts that may reduce a borrower's ability to repay the automobile loan. The agencies have continued to find a 36 percent DTI ratio to be an appropriately conservative measure of ability to repay commensurate with a high quality automobile loan with low credit risk. Regarding verification, the agencies are concerned that not all of a borrower's liabilities may be listed on a credit report and therefore are adopting the verification standards as proposed. In addition, relying on borrower stated income in assessing ability to repay could lead to overstatement of income by the borrower to obtain the loan or by the originator to qualify the loan as a QAL. For these reasons, as well as those discussed in the reproposal, the agencies are adopting the DTI and verification requirements as reproposed.

2. Loan Terms

As noted above, the reproposal included a number of criteria relating to the automobile loan, including that the loan term be calculated based on the origination date and loan payments could not be contractually deferred.

A commenter requested that the loan term be calculated from the date of first payment rather than the origination date. Commenters also requested that loan deferrals be allowed to assist borrowers with hardship events.

The agencies observe that the loan origination date and date of first payment should usually be within a few weeks of each other, which would not materially affect the loan term. The agencies do not view a long period prior to the first payment date as consistent with a strong QAL standard, as it could extend the total loan term for months beyond the limits for maturity the agencies have identified as appropriate for a QAL. While the agencies are retaining the requirement that the contract not allow borrower-initiated payment deferrals, this requirement would not affect subsequent servicer-initiated deferrals that may be triggered by borrower hardships described by the commenters. For these reasons and those discussed in the revised proposal, the agencies are finalizing the loan term criteria as proposed.

3. Reviewing Credit History

In the reproposal, the QAL criteria included an originator verification, within 30 days of originating a QAL, that the borrower was not 30 days or more past due on any obligation; was not more than 60 days past due over the past two years on any obligation; and was not a judgment debtor or in bankruptcy in the past three years. The agencies also proposed a safe harbor enabling the originator to rely on a borrower's credit report showing the borrower complies with the standards. Also, the agencies proposed a requirement that all QALs be contractually current at the closing of the securitization.

Several commenters opposed the proposed credit history criteria and requested that the agencies use instead a credit scoring system based on FICO or a similar system of rating potential borrowers based on credit history, generally using proprietary models. Commenters pointed out that the automobile lending industry has used credit scoring as a primary underwriting tool and would be unable under the QAL criteria to continue to rely on that method for qualifying its best borrowers, and therefore would not be able to use the criteria in order not to lose those borrowers as customers.

Commenters further asserted that the proposed credit history verification criteria would be more burdensome than credit scoring systems, thereby increasing costs for lenders and consumers. A commenter suggested that the criteria would result in conclusions possibly less objective than credit scoring systems. In addition, a few commenters claimed that the QAL credit history standards would exclude many consumers of good credit quality while failing to identify risky consumers, whereas credit scoring models used in the industry would more accurately discriminate between

[259] See 15 U.S.C. 78o–11(c)(1)(B)(ii).

high and low-credit quality borrowers. These commenters asserted that this result would occur because the proposed criteria do not capture many aspects of credit history that are captured by credit scoring models. The commenters also recommended that the agencies adopt a ''vendor-neutral'' approach to incorporating the use of credit scores in the QAL criteria to ensure that there would be no undue reliance on a particular vendor and that credit models are already subject to regulatory oversight (including being the subject of the banking agencies' guidance on model validation) and are rigorously validated. A commenter pointed to the FDIC's large bank assessment rule [260] as an example of how the agencies could adopt a vendor-neutral credit score criterion into the QAL criteria. Some commenters also requested that the agencies define ''contractually current'' and base compliance on the securitization cut-off date rather than the closing date.

The agencies have carefully considered the comments regarding the proposed QAL criteria and the requests to use credit scoring in the criteria. The agencies recognize that much of the current automobile lending industry relies heavily or solely on an internally or externally developed credit scoring system to approve automobile loans. However, the agencies do not believe that a credit score alone is sufficient underwriting for a conservative automobile loan with a low risk of default. Furthermore, the agencies do not believe it is appropriate for purposes of risk retention to establish regulatory requirements that rely on a credit scoring system or combination of proprietary credit scoring systems. The agencies are concerned that, over time, market pressures around meeting QAL criteria or other factors could lead to distortions in the scoring systems that do not appropriately reflect credit risk. Additionally, the agencies have broad policy concerns with linking regulatory underwriting criteria for risk retention purposes to proprietary credit analyses using privately developed models.

Additionally, the agencies believe that a borrower must be contractually current on the loan obligation prior to securitization in order to have a robust underwriting requirement. However, the agencies do not believe it is necessary to establish a definition of contractually current, instead leaving this decision to the contract between the originator and borrower. While the agencies believe a securitization exempt from risk retention should contain only current automobile loans, the agencies will adopt the commenters' suggestion to require evaluation of a loan's status based on the cut-off date or similar date for establishing the composition of the asset pool collateralizing asset-backed securities issued pursuant to a securitization transaction rather than the closing date of the securitization.

For these reasons, the agencies are adopting the credit history criteria as set forth in the revised proposal.

4. Down Payment Requirement

As noted above, the proposed QAL criteria included a down payment requirement whereby automobile loan borrowers would have been required to pay 100 percent of the taxes, fees, and extended warranties in addition to 10 percent of the net purchase price (negotiated price less manufacturer rebates and incentive payments) of the car.

Most comments on the QAL criteria opposed the proposed down payment requirements. The commenters proposed eliminating the down payment entirely, eliminating the down payment requirement for the taxes, fees, and extended warranties, or reducing the down payment requirement on the net purchase price. One of these commenters asserted that prime automobile loans do not require down payments generally because vehicles depreciate rapidly and therefore, lenders generally do not rely significantly on the value of the collateral when underwriting. Furthermore, the commenter asserted that depreciation makes strategic defaults highly unlikely and the short term of most automobile loans makes down payments unnecessary. As with the verification requirements discussed above, the commenter claimed that the down payment requirement in the QAL criteria could put automobile lenders that use securitization financing at a disadvantage as compared to others because of increased burden on consumers in meeting the QAL criteria or having more costs due to risk retention. The commenter also asserted that down payments have far less relevance to the credit risk of automobile loans than they do to residential loans, and that having such a requirement in the QAL criteria would not be consistent with the agencies' position on the QRM definition.

As discussed in the reproposal, the agencies do not believe that an automobile loan with an LTV ratio over 90 percent would be low-risk, and that a customer should put some of the customer's own cash or trade-in value into the deal to reduce risks for strategic default and incent repayment of the loan. The agencies recognize that down payment requirements for prime borrowers are not common in automobile lending, but note that down payments provide an additional level of protection to lenders and investors in automobile securitizations that ensures a low level of credit risk over time as market conditions change.

For the reasons discussed above, the agencies are adopting the QAL criteria as set forth in the reproposal. As explained above, the criteria ensure that QAL loans (that are fully exempt from risk retention) are of very high quality and low credit risk, as required by section 15G of the Exchange Act.[261] The agencies recognize that the QAL standards are in some respects more conservative than those of the QRM definition. The agencies observe, however, that the statutory standards for establishing QAL criteria and the QRM definition are different.[262] Furthermore, as discussed in the reproposal and Part VI of this Supplementary Information, the agencies' decisions with regard to the QRM definition take into consideration the particular dynamics in the residential mortgage market and the effect of that market on the economy. The dynamics in the automobile market are different, as are the effects of the automobile market on the broader financial system and economy, and the agencies have therefore considered the automobile and residential markets separately, together with the differences in the relevant statutory requirements, in establishing the QRM and QAL standards.

VI. Qualified Residential Mortgages

After carefully considering comments received on the reproposed definition of QRM, as well as comments received on the alternative approach to defining QRM, the agencies are adopting, as reproposed, the definition of QRM that aligns with the definition of QM, as defined in section 129C of TILA [263] and the regulations thereunder. The agencies are also providing an exemption from risk retention requirements for certain mortgage loans secured by three-to-four unit residential properties that meet the criteria for QM other than being a consumer credit, as well as an exemption to permit sponsors to blend these exempted mortgage loans with QRMs.

The final rule also includes a separate exemption from risk retention

[260] 12 CFR part 327.

[261] *See* 15 U.S.C. 78o–11(c)(2)(B).

[262] *See id.* at sections 78o–11(c)(2)(B) and 78–11(e)(4)(B).

[263] 15 U.S.C. 1639c.

requirements for certain types of community-focused residential mortgages that are not eligible for QRM status under the rule, similar to the exemptions provided from Regulation Z's ability-to-repay requirement.[264]

The agencies are also including a provision in the final rule that will require the agencies to periodically review the definition of QRM and its effect on the mortgage securitization market, as well as the exemptions provided for the three-to-four unit residential properties and the community-focused residential mortgages. Each of these aspects of the final rule is discussed more fully below.

A. Background

Section 15G of the Exchange Act exempts sponsors of securitizations from the risk retention requirements if all the assets that collateralize the securities issued in the transaction are QRMs.[265] In defining QRM, the statute requires that the agencies take into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default. In addition, the statute requires that the definition of QRM be ''no broader than'' the definition of QM.[266]

In the original proposal, the agencies proposed to define QRM to mean a covered closed-end credit transaction that meets the statutory QM standards[267] as well as additional underwriting criteria. These additional underwriting criteria included minimum LTV and down payment requirements, DTI requirements, and credit history criteria.[268] These additional criteria were developed after the agencies examined extensive data on loan performance from several sources,[269] and were based on several goals and principles the agencies articulated in the original proposal.[270] The agencies also sought to implement the statutory requirement that the definition of QRM be no broader than the definition of a QM, as mandated by the Dodd-Frank Act.[271] At the time of the original proposal, the definition of QM had not been adopted in a final rule.

The majority of commenters opposed the QRM definition in the original proposal, expressing concerns over the 20 percent down payment requirement in particular. These commenters stated that the proposed definition of QRM was too narrow and would constrain credit availability, especially for low- and moderate-income (LMI) borrowers or first-time homebuyers. Many of these commenters urged the agencies to postpone finalizing the QRM definition until after the QM definition was finalized by the CFPB.[272]

As discussed in the reproposal, in deciding to propose a broader QRM definition, the agencies carefully considered the concerns raised by commenters with respect to the original proposed definition, the cost of risk retention, current and historical data on mortgage lending and performance, and the provisions of the final QM definition. The agencies examined updated loan performance information and considered the historical performance of residential mortgage loans with respect to the QM criteria.[273] Further, the agencies considered the potential effects of a QRM definition on credit pricing and access under prevailing market conditions, as well as direct and indirect costs of lending that could be passed on to borrowers and restrict credit availability.[274]

The agencies decided in the reproposal to align the QRM definition with the QM definition for several key reasons, which include meeting the statutory goals and directive under section 15G of the Exchange Act to limit credit risk, preserving access to affordable credit, and reducing compliance burden. Among other factors related to credit risk, the agencies discussed in the reproposal observations that loans that meet the QM criteria have a lower probability of default than mortgages that do not, most notably for loans originated near the peak of the housing bubble that preceded the financial crisis.[275] In addition, the agencies observed that a QRM definition aligned with QM should limit the scope of information asymmetry between sponsors and investors because the QM definition requires, among other things, documentation and verification of income and debt.[276] In addition, the agencies expressed concern about imposing further constraints on mortgage credit availability under the prevailing tight mortgage lending conditions, including through additional criteria that could reduce the credit risk of QRMs further, such as LTV and credit history-related criteria. The agencies also observed that the indirect costs of the interaction of QRM with existing regulations and market conditions is difficult to quantify and has the potential to be large, and that aligning the QRM definition with the QM definition should minimize these costs.[277] Finally, the agencies noted with concern that a QRM definition not aligned with the QM definition could compound the segmentation in the securitization market that may already occur between QMs and non-QMs. It was acknowledged that, while the agencies recognized that the alignment of QRM with QM could also further solidify the non-QM/QM segmentation in the market, the consequences of segmentation due to non-alignment were judged to be more severe.[278]

In reproposing to align the QRM definition with QM, the agencies expressed an intention to review the advantages and disadvantages of this decision as the market evolves, to ensure the risk retention rule best meets

[264] *See* Part VII of this Supplementary Information.

[265] *See* 15 U.S.C. 78o–11(c)(1)(C)(iii).

[266] *See id.* at section 78o–11(e)(4).

[267] Under the original proposal, QRM was limited to a closed-end first-lien mortgage to purchase or refinance a one-to-four family property, at least one unit of which is the principal dwelling of a borrower. In addition, consistent with the QM requirement under section 129C(b)(2) of TILA, the maturity date of a QRM could not exceed 30 years and QRMs would have been prohibited from having, among other features, payment terms that allow interest-only payments, negative amortization, ''balloon payments,'' or prepayment penalties. *See* Original Proposal, 76 FR at 24122.

[268] *See* Original Proposal, 76 FR at 24117.

[269] The agencies reviewed data supplied by McDash Analytics, LLC, a wholly owned subsidiary of Lender Processing Services, Inc., on prime fixed-rate loans originated from 2005 to 2008, which included underwriting and performance information on approximately 8.9 million mortgages; data from the 1992 to 2007 waves of the triennial Survey of Consumer Finances, which focused on respondents who had purchased their homes either in the survey year or the previous year, and included information on approximately 1,500 families; and data regarding loans purchased or securitized by the Enterprises from 1997 to 2009, which consisted of more than 78 million mortgages, and included data on loan products and terms, borrower characteristics (*e.g.,* income and credit score), and performance data through the third quarter of 2010. *See* Original Proposal, 76 FR at 24152.

[270] First, the agencies stated that QRMs should be of very high credit quality, given that Congress exempted QRMs completely from the credit risk retention requirements. Second, the agencies recognized that setting fixed underwriting rules to define a QRM could exclude many mortgages to creditworthy borrowers. Third, the agencies sought to preserve a sufficiently large population of non-QRMs to help enable the market for securities collateralized by non-QRM mortgages to be relatively liquid. Fourth, the agencies sought to implement standards that would be transparent and verifiable to participants in the market. *See* Original Proposal, 76 FR at 24117.

[271] *See* 15 U.S.C. 78o–11(e)(4)(C). At the time of issuance of the original proposal on April 29, 2011, the Board had sole rulemaking authority for defining QM, which authority transferred to CFPB on July 21, 2011, the designated transfer date under the Dodd-Frank Act.

[272] *See* Final QM Rule.

[273] *See* Revised Proposal, 78 FR at 57989–57990.

[274] *See id.* at 57991.

[275] *See id.* at 57989.

[276] *See id.* at 57990.

[277] *See id.* at 57991.

[278] *See id.*

the statutory objectives of section 15G of the Exchange Act.[279]

B. Overview of the Reproposed Rule

The reproposal would have implemented the statutory exemption for QRMs by defining ''qualified residential mortgage'' to mean ''qualified mortgage'' as defined in section 129C of TILA [280] and the regulations issued thereunder.[281] The agencies proposed to align the definition of QRM with QM to minimize potential conflicts between the two definitions and minimize burden in meeting both QM and QRM criteria. Therefore, under the reproposal, a QRM would have been a loan that

(i) Met the general criteria for a QM under section 1026.43(e)(2);

(ii) Met the special criteria of the temporary QM definition under section 1026.43(e)(4);

(iii) Met the criteria for small creditor portfolio loans under section 1026.43(e)(5) or (e)(6); or

(iv) Met the criteria for rural or underserved creditor balloon loans under section 1026.43(f).

This reproposed definition of QRM included any closed-end loan secured by any dwelling (*e.g.,* home purchase, refinances, home equity loans, second or vacation homes), whether a first or subordinate lien. However, the reproposed definition of QRM would not have included any loan exempt from the ability-to-repay requirements and not eligible to be a QM, such as home-equity lines of credit (HELOCs) or reverse mortgages.[282] In addition, loans exempt from the ability-to-repay requirements (such as loans made through state housing finance agency programs and certain community lending programs) were not separately included in the definition of QRM, which under the statute cannot be broader than QM.

The agencies invited comment on all aspects of the reproposed definition of QRM. In particular, the agencies asked whether the reproposed definition would reasonably balance the goals of helping to ensure high quality underwriting and appropriate risk management with the public interest in continuing access to credit for creditworthy borrowers. The agencies also asked whether the definition of QRM should be limited to certain QM loans, such as loans that qualify for the QM safe harbor under 12 CFR 1026.43(e)(1), and if the reproposed definition of QRM should include loans secured by subordinate liens. In addition, the agencies invited comment on an alternative approach to defining QRM (QM-plus approach). Consistent with the statutory requirement that QRM be no broader than QM, the QM-plus approach would have taken the CFPB's definition of QM as a starting point, including the requirements for product type, loan term, points and fees, underwriting, income, and debt verification, and DTI,[283] and added four additional factors: the loan would have had to be a first-lien mortgage loan, be secured by a one-to-four family principal dwelling, and have an LTV ratio of 70 percent or less, and the borrower would have had to meet specific credit history criteria.[284] Under this approach, significantly fewer loans likely would have qualified as QRMs. The agencies asked a number of questions about the QM-plus approach, including whether the benefits of the QM-plus approach would exceed the benefits of the reproposed approach to align the QRM definition to QM, taking into consideration financial stability, credit access, and regulatory burden.[285]

C. Overview of Public Comments

1. Comments Received on the Reproposed QRM Definition

The agencies received a significant number of comments with respect to the reproposed QRM definition, with most commenters expressing support for the reproposal that would align the QRM definition with the QM definition. Generally, these commenters stated that aligning the two definitions would comply with statutory requirements, minimize negative impact on the availability and cost of credit to borrowers (especially LMI borrowers, minority borrowers, and first-time homebuyers), and reduce potential costs, regulatory uncertainty, and compliance burden. Some commenters specifically expressed support for retaining the proposed full alignment with QM so that the proposed QRM definition would not distinguish between loans that receive a ''safe harbor'' or a ''rebuttable presumption'' of compliance under the QM provisions. Some commenters requested clarifications, expressed concerns, or suggested modifications to the proposed QRM definition, including with respect to loans exempted from the ability-to-repay rules under TILA, which are discussed and addressed in more detail in Part VII of this Supplementary Information.

Several commenters opposed aligning the QRM definition with the QM definition, asserting that such an approach would be contrary to statutory intent. These commenters asserted that the definitions of QRM and QM have distinct and different purposes, with the former addressing risk posed to investors and the latter addressing consumer protection. These commenters further stated that broadening the QRM definition would reduce the effect of the risk retention rule with respect to residential mortgages, which comprised one of the main securitization markets that led to the financial crisis. These commenters also expressed concern that the proposed QRM definition would be insufficient to support the credit quality on which a stable mortgage market depends.

Most commenters that opposed the revised definition of QRM supported most, if not all, aspects of the QRM definition in the original proposal and recommended that the agencies adopt that QRM definition instead. These commenters asserted that LTV and credit history requirements are key criteria to ensure that QRMs represent a lower risk of default and the risk retention rules offer some protection to RMBS investors. One commenter asserted that the reproposed QRM definition is based on the same credit reporting requirements used prior to the financial crisis and continues to lack credit reporting verification safeguards to ensure completeness and accuracy. Another commenter suggested that the agencies require a loan-level credit enhancement when QM loans exceed a stated LTV ratio.

A few commenters expressed concern about the potential effects the reproposed QRM definition might have on the market, in that QMs and QRMs could become the only type of mortgage loans made and accepted on the secondary market, or that the market may shift more towards federally insured or guaranteed mortgages.

Finally, commenters requested that the agencies clarify that the requirement that a depositor certify as to the effectiveness of its internal supervisory controls with respect to the process for ensuring that mortgages included in a pool of QRM assets qualify as QRMs does not impose an obligation on sponsors to guarantee that all assets are, in fact, QRMs. As is indicated by the final rule's provision of a buyback option for non-compliant assets, the agencies do not view the certification as requiring that the controls guarantee compliance. Rather, the process must be

[279] *See id.*

[280] 15 U.S.C. 1639c.

[281] *See* Final QM Rule.

[282] See 12 CFR 1026.43(a) and 1026.43(c).

[283] *See* Revised Proposal, 78 FR at 57993–57996.

[284] *See* Revised Proposal, 78 FR at 57993.

[285] *See id.* at 57995.

robust and sufficient to enable the sponsor to carefully evaluate eligibility.

2. Comments Received on the Alternative Approach to QRM

The agencies also received numerous comments on the alternative QM-plus approach. Commenters generally opposed the QM-plus approach, asserting that it would be too restrictive, impose additional compliance costs, and have a negative effect on the availability of affordable credit, especially to LMI borrowers, minority borrowers, and first-time homebuyers. In addition, many commenters expressed concern that a QM-plus approach would slow the return of private capital in the mortgage market because it would increase government and agency involvement in the mortgage market and would make it more difficult for sponsors to assemble a critical mass of QRMs necessary for a securitization. Commenters also expressed concern that mortgages meeting the QM-plus standard would effectively become the primary mortgage product available, thus pushing out other mortgage loans that would qualify as QMs from the mortgage market. Some commenters supported a narrow definition of QRM as reflected in the QM-plus approach, but generally recommended that the agencies adopt the original proposed QRM definition rather than the QM-plus approach.

One commenter specifically expressed concern about the exclusion of secondary liens from the QM-plus approach, asserting that secondary liens facilitate credit to borrowers and benefit the economy. Another commenter asserted that because the QM-plus approach was described only in the preamble, there was insufficient information to determine how the QM-plus approach would be implemented. Some commenters requested specific changes if the agencies were to go forward with the QM-plus approach, including a lower down payment requirement, the exclusion of piggyback loans, and the inclusion of credit scores.

D. Summary and Analysis of Final QRM Definition

1. Alignment of QRM With QM

After carefully considering the comments received, the agencies are adopting a definition of QRM that is aligned with the definition of QM, with some modifications. Accordingly, the final rule defines a QRM to mean a QM, as defined under section 129C of TILA and the regulations issued thereunder, as may be amended from time to time. The agencies also believe it is necessary to periodically review the QRM definition to take into account developments in the residential mortgage market, as well as the results of the CFPB's five-year review of the ability-to-repay rules and the QM definition, which is required under section 1022(d) of the Dodd-Frank Act.[286] Therefore, the final rule also includes a provision that requires the agencies to conduct a periodic review of the definition of QRM, which is discussed more fully below.

The agencies have declined to adopt the QM-plus approach or the approach from the original proposal. While the additional requirements in those two approaches may include useful factors in determining the probability of mortgage default, these additional credit overlays may have ramifications for the availability of credit that many commenters asserted were not outweighed by the corresponding reductions in the likelihood of default from including these determinants in the QRM definition. The agencies are concerned about the prospect of imposing potential additional constraints on mortgage credit availability at this time, especially as such constraints might disproportionately affect LMI, minority, or first-time homebuyers.

The agencies continue to believe that a QRM definition aligned with the definition of QM meets the statutory goals and directive of section 15G of the Exchange Act to limit credit risk and promote sound underwriting. At the same time, the agencies believe this definition will also meet the important goals of preserving access to affordable credit for various types of borrowers and facilitating the return of private capital to the mortgage market. Furthermore, the agencies believe this definition appropriately minimizes regulatory compliance burdens in the origination of residential mortgage loans. The final definition of QRM does not incorporate either an LTV ratio requirement or standards related to a borrower's credit history, such as those in the alternative QM-plus approach discussed in the reproposal. As the agencies explained in the reproposal, although credit history and LTV ratio are significant factors in determining the probability of mortgage default and are important aspects of prudent underwriting, on balance, the agencies believe policy considerations weigh in favor of aligning QRM with QM at this time.

Consistent with the discussion in the reproposal, the agencies believe that a QRM definition that is aligned with the QM definition meets the statutory requirement to take into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default.[287] The criteria of the QM definition support this determination. The QM criteria are structured to help ensure that borrowers are offered and receive residential mortgage loans that borrowers can afford. For example, the QM definition requires full documentation and verification of consumers' debt and income, and generally requires borrowers to meet a DTI threshold of 43 percent or less, which helps to address certain underwriting deficiencies, such as the existence of subordinate liens, and may help to reduce incidents of mortgage fraud. The QM definition also restricts the use of certain product features, such as negative amortization, interest-only and balloon payments (except as provided under special definitions available only to small portfolio creditors) that historical data have shown correlate to higher rates of default. As discussed in the reproposal, formal statistical models indicate that borrowers with mortgages that do not meet these aspects of the QM definition rule exhibit higher probabilities of default.[288] Consistent with these statistical models, historical data indicate that borrowers with mortgages that meet the QM criteria have lower probabilities of default than those with mortgages that do not meet the criteria.[289]

The agencies continue to believe that aligning the QRM and QM definitions at this time will help promote access to affordable credit by minimizing additional regulatory burden and compliance cost and facilitating the return of private capital to the mortgage market. Although mortgage lending conditions appear to have been easing gradually for several quarters, standards overall remain tight, especially for borrowers with lower credit scores or fewer funds for a down payment. In the July 2014 Senior Loan Officer Opinion Survey of Bank Lending Practices, approximately a fourth of all banks surveyed reported that they had eased their standards for prime residential

[286] *See* 12 U.S.C. 5512.

[287] 15 U.S.C. 78o–11(e)(4).

[288] *See* Shane M. Sherlund, ''The Past, Present, and Future of Subprime Mortgages,'' *Finance and Economics Discussion Series,* Paper 2008–63 *available at http://www.federalreserve.gov/pubs/feds/2008/200863/200863pap.pdf*; Ronel Elul, Nicholas S. Souleles, Souphala Chomsisengphet, Dennis Glennon, and Robert Hunt. ''What 'Triggers' Mortgage Default?'' *American Economic Review* 100 (May 2010): 490–494.

[289] For further detail, see Revised Proposal, 78 FR at 57989–57990.

mortgages in the second quarter of 2014.[290] However, approximately half of the banks surveyed reported that their standards for prime conforming residential mortgages were tighter than the midpoint of their longer-term ranges. Even more lenders reported levels of standards that were tighter than historical averages for jumbo, nontraditional, and subprime mortgages. Likewise, the Mortgage Bankers Association's index of mortgage credit availability—designed to capture the credit risk profile of mortgages being offered in the market place—edged up over the first few months of 2014, suggesting that mortgage credit conditions continue to improve. Nonetheless, comparisons of this index to a roughly equivalent proxy for lending conditions in 2004 suggest that credit availability is quite restricted.

An additional manifestation, in part, of tight credit standards is the subdued level of mortgage and housing activity. Mortgage applications in the first six months of 2014, as measured by the Mortgage Bankers Association application indexes, were at the lowest levels since the 1990s. Existing home sales rose only 3.5 percent in the first six months of 2014 and are still roughly 25 percent below their 2004 level. In addition, the private-label RMBS market remains extremely small and limited to mortgages of very high credit quality. In the second quarter of 2014, less than 1 percent of mortgage originations were funded through private-label RMBS.[291] The securitizations that were issued were collateralized by mortgages with a weighted average loan-to-value ratio of around 70 percent and, in most cases, weighted average credit scores greater than 750.

At the same time, several mortgage and securitization regulatory changes have been put in place that increase the amount of information available to investors, improve mortgage underwriting, and increase investors' ability to exercise their rights and obtain recoveries in the event of mortgage default. For example, the CFPB has implemented regulations governing mortgage servicing and loan originator compensation in addition to the ability-to-repay rule and QM standards. The ability-to-repay rule is particularly noteworthy for requiring loan originators to document income, debts, and other underwriting factors, which should in turn provide investors a more complete set of information on which to base their investment decision. The Commission recently adopted revisions to Regulation AB that, among other things, require disclosure in registered RMBS transactions of detailed loan-level information at the time of issuance and on an ongoing basis. These revisions also require that securitizers provide investors with this information three business days prior to the first sale of securities so that they can analyze this information when making their investment decision.[292] The Commission also has proposed rules required by section 621 of the Dodd-Frank Act [293] that would prevent sponsors and certain other securitization participants from engaging in material conflicts of interest with respect to their securitizations.[294] Additionally, the Board, the FDIC, the OCC, the FHFA and the Commission, among other federal agencies, have jointly proposed rules required by section 956 of the Dodd-Frank Act [295] that would enhance reporting and oversight of incentive-based compensation practices and prohibit compensation arrangements that encourage inappropriate risk taking by financial institutions.[296] These regulatory actions are further complemented by efforts on the part of the Enterprises and the industry to improve standards for due diligence, representations and warranties, appraisals, and loan information.[297] Although additional changes may be necessary, taken together, these changes and the other changes to be completed provide additional support for aligning the definition of QRM with that of QM.

2. Periodic Review of the QRM Definition

The agencies recognized that aligning the QRM definition with the QM definition could have potential problematic effects on securitization markets, such as increasing of bifurcation in the mortgage market between QM and non-QM loans. Although the agencies continue to believe the benefits of the alignment at this time outweigh these potential risks, the agencies stated in the reproposal that they intended to review the advantages and disadvantages of aligning the QRM and QM definitions as the market evolves.[298]

The agencies are adopting the reproposed QRM definition, but also recognize that mortgage and securitization market conditions and practices change over time, and therefore, believe it would be beneficial to periodically review the QRM definition. Thus, the agencies are committing in the final rule to review the QRM definition at regular intervals to consider, among other things, changes in the mortgage and securitization market conditions and practices (which may include, for example, the structures of securitizations, the relationship between, and roles undertaken by, the various transaction parties, implications for investor protection and financial stability arising from the relationship between Enterprise markets and private label markets, and trends in mortgage products in various markets and structures), as well as how the QRM definition is affecting residential mortgage underwriting and securitization of residential mortgage loans under evolving market conditions. The agencies also want the opportunity to consider the results of future reviews of, and any changes made to, the QM definition by the CFPB, any additional regulatory changes affecting securitization that are adopted by the agencies, as well as any changes to the structure and framework of the Enterprises and those markets. As a result of these reviews, the agencies may or may not decide to modify the definition of QRM. Any such modification would occur through notice and comment rulemaking. Otherwise, any changes the CFPB makes to the QM definition automatically will modify the QRM definition.

As provided in the final rule, the agencies will commence a review of the definition of QRM not later than four years after the effective date of this rule with respect to securitizations of residential mortgages, five years after the completion of that initial review, and every five years thereafter. In addition, the agencies will commence a review at any time upon the request of any one of the agencies. The agencies will jointly publish in the **Federal Register** notice of the commencement of a review, including the reason for the review if it has been initiated upon the request of one of the agencies. In the

[290] Senior Loan Officer Opinion Survey of Bank Lending Practices, Board of Governors of the Federal Reserve System (July 2014), *available at http://www.federalreserve.gov/boarddocs/SnLoanSurvey/201408/default.htm.*

[291] Mortgage Bankers Association, Quarterly Mortgage Originations Estimates as of July 2014; Intex Solutions, Inc., and Asset-Backed Alert, prime non-agency RMBS issued in second quarter of 2014.

[292] *See* Asset-Backed Securities Disclosure and Registration; Final Rule, 79 FR 57184 (Sept. 24, 2014).

[293] 15 U.S.C. 77z–2a.

[294] *See* Prohibition Against Conflicts of Interest in Certain Securitizations; Proposed Rule, 76 FR 60320 (Sept. 28, 2011).

[295] 12 U.S.C. 5641.

[296] *See* Incentive-Based Compensation Arrangements; Proposed Rule, 76 FR 21170 (Apr. 14, 2011).

[297] *See* Revised Proposal, 78 FR at 57990.

[298] *See* Revised Proposal, 78 FR at 57991.

notice, the agencies will seek public input on the review. The agencies intend to complete each review no later than 6 months after initial notice of the review, subject to extension by the agencies as conditions warrant. Following the review, the agencies will jointly publish a notice that includes their conclusions from the review and, as part of such review, take whatever action is required by applicable law, including the Administrative Procedure Act. If, as a result of the review, the agencies decide to modify the definition of QRM, the agencies will complete such rulemaking within 12 months of publication in the **Federal Register** of the notice disclosing the determination of their review, unless extended by the agencies.

The agencies intend for their initial review of the QRM definition to be completed after the publication of the report of the CFPB's assessment of the ability-to-repay rules, including the QM definition, which the CFPB is required to publish within five years of the effective date of the ability-to-repay rule (*i.e.,* January 10, 2019).[299] However, as noted above, the agencies' initial review will start no later than four years after the effective date of this final rule with respect to residential mortgages. The agencies believe this timing helps to ensure the initial review of the QRM definition benefits from the CFPB's review and course of action regarding the definition of QM, and will help the agencies in determining whether the QRM definition should continue to align fully with the QM definition in all aspects. Furthermore, the agencies expect additional information on the housing and mortgage market will be available at the time the initial review is conducted that would be important in determining whether the then-current QRM definition remains appropriate under prevailing market conditions and continues to meet the requirements and policy purposes of section 15G of the Exchange Act.

3. Definition of QRM

Under the final rule, QRM is defined by aligning it to the definition of QM in the CFPB regulations under section 129C of TILA. A QRM is a loan that is a ''covered transaction'' [300] that meets the general definition of a QM. The general definition of a QM provides that the loan must have:

- Regular periodic payments that are substantially equal;
- No negative amortization, interest only or balloon features;
- A maximum loan term of 30 years;
- Total points and fees that do not exceed 3 percent of the total loan amount, or the applicable amounts specified for small loans up to $100,000;
- Payments underwritten using the maximum interest rate that may apply during the first five years after the date on which the first regular periodic payment is due;
- Consideration and verification of the consumer's income and assets, including employment status if relied upon, and current debt obligations, mortgage-related obligations, alimony and child support; and
- Total DTI ratio that does not exceed 43 percent.[301]

In addition, in the final rule, the definition of QRM includes loans that meet one of the special types of QMs. One special QM is a covered transaction that meets the CFPB's temporary government QM definition.[302] A loan eligible under the temporary QM definition must satisfy the loan-feature limitations of the general definition of a QM: the loans must have substantially equal periodic payments, with no interest-only, negative amortization or balloon features; must have a maximum 30-year term; and must comply with the points and fees limitations.[303] However, the loans are not subject to the underwriting provisions of the general QM definition, such as the total DTI ratio requirement of 43 percent or less. To be eligible under the CFPB's temporary government QM definition, loans must be eligible for purchase, guarantee or insurance by an Enterprise, U.S. Department of Agriculture (USDA), or Rural Housing Services (RHS).[304]

As discussed in the reproposal, the temporary QM definition with respect to an Enterprise expires once the Enterprise exits conservatorship, but in any case no later than January 21, 2021.[305] Additionally, the temporary QM definition with respect to USDA and RHS expires when USDA and RHS issue their own QM rules or, in any case, no later than January 21, 2021.[306]

Lastly, a QRM is a loan that meets the definitions of QM issued by HUD, the Department of Veterans Affairs (VA), USDA, and RHS under section 129C of TILA. HUD, VA, USDA, and RHS each have authority under the Dodd-Frank Act to define QM for their own loans. Specifically, section 129C(a)(3) of TILA authorizes these agencies to issue rules implementing the QM requirements under section 129C(a)(2) of TILA. USDA and RHS have not yet issued rules under section 129C of TILA

On December 11, 2013, HUD adopted a final rule to define QM for the single family residential loans that it insures, guarantees or administers and which took effect on January 10, 2014.[307] In addition, the VA issued an interim final rule to define QM for loans that it insures or guarantees, with an effective date of May 9, 2014.[308] Accordingly, the final definition of QRM now includes any loan insured, guaranteed or administered as a QM under either the HUD or VA definition of QM, as applicable.

In the final rule, the definition of QRM also includes a loan that meets any of the special QM definitions designed to facilitate credit offered by small creditors.[309] To qualify as a ''small creditor'' eligible under one of these special QM definitions, however, the entity must meet certain asset and threshold criteria and hold the QM loans in portfolio for at least three years, with certain exceptions.[310] Thus, loans meeting these special small creditor QM definitions would generally be ineligible for securitization as QRMs for three years following consummation.

A loan eligible under these special ''small creditor'' QM definitions must meet the general requirements of a QM,[311] except that these loans receive greater underwriting flexibility (*i.e.,* do not need to meet the quantitative DTI threshold of 43 percent or less).[312] Additionally, a loan originated by a qualifying small creditor may contain a balloon feature if the loan is originated during the two-year transition period, which expires January 10, 2016, provided the loan meets certain other criteria, such as a 5-year minimum term.[313] After January 10, 2016, the ability to write a balloon QM will be limited to small creditors that operate

[299] *See* 12 U.S.C. 5512.

[300] *See* 12 CFR 1026.43(b)(1), which defines ''covered transaction'' as a consumer credit transaction that is secured by a dwelling, as defined in section 1026.2(a)(19), including any real property attached to a dwelling, other than a transaction exempt from coverage under section 1026.43(a) (*i.e.,* HELOCs, time shares, reverse mortgages, temporary or ''bridge'' loans of 12 months or less, and certain construction loans).

[301] *See* 12 CFR 1026.4(e)(2).

[302] *See* 12 CFR 1026.43(e)(4).

[303] *See* 12 CFR 1026.43(e)(2) and 1026.43(e)(4).

[304] *See* 12 CFR 1026.43(e)(4)(ii).

[305] *See* 12 CFR 1026.43(e)(4)(iii).

[306] *See id.*

[307] *See Qualified Mortgage Definition for HUD Insured and Guaranteed Single Family Mortgages,* 78 FR 75215 (Dec. 11, 2013).

[308] *See Loan Guaranty: Ability-to-Repay Standards and Qualified Mortgage Definition Under the Truth in Lending Act,* 79 FR 26620 (May 9, 2014).

[309] *See* 12 CFR 1026.43(e)(5) and (e)(6).

[310] *See* 12 CFR 1026.43(e)(5), (e)(6), and (f).

[311] *See* 12 CFR 1026.43(e)(2).

[312] *See* 12 CFR 1026.43(e)(5), (e)(6), and (f).

[313] *See* 12 CFR 1026.43(e)(6).

primarily in rural or underserved areas.[314]

Consistent with the reproposed definition described above, the final definition of QRM includes any closed-end loan secured by any dwelling (*e.g.,* home purchase, refinances, home equity loans, second or vacation homes, and mobile homes, and trailers used as residences), whether a first or subordinate lien.[315] The final definition of QRM does not include any loan exempt from the ability-to-repay requirements under TILA and the ability-to-repay rules, such as HELOCs, reverse mortgages, timeshares or temporary or ''bridge'' loans of 12 months or less.[316] In addition, the final definition of QRM does not include those loans that were provided a regulatory exemption from the ability-to-repay rules, such as loans made through state housing finance agency programs and certain community lenders. If a loan is not subject to TILA because it is deemed to be extended for a business purpose, it is also not included in the definition of QM (and therefore, is not a QRM). The agencies believe this approach is consistent with the language and intent of section 15G of the Exchange Act, whereby a QRM can be no ''broader than'' a QM.

To provide relief from risk retention for mortgage loans that are collateralized by three-to-four unit residential properties and are not included in the QRM definition because they are deemed not to be covered transactions in the QM definition, but that otherwise meet all the criteria to be a QM, the final rule includes a separate exemption, as discussed further below in Part VII of this Supplementary Information.

Several commenters requested that the agencies clarify that the incorporated QM definition include all statutory provisions, the regulation, the regulation's commentary and appendix, and future supporting guidance to prevent any difficult interpretive questions about whether it is possible for a loan to be a QM and not a QRM. As noted above, the agencies are defining QRM by cross-reference to the definition of QM under section 129C of TILA, and any regulations issued thereunder, to avoid potential conflicts between the definitions of QRM and QM and to facilitate compliance. By cross-referencing to the definition of QM, the final rule incorporates any rules issued under section 129C of TILA that define QM, including any Official Interpretation that interprets such rules.

The rule provides that QRM means QM as amended by the CFPB from time to time. As such, the rule presumes that each amendment to the definition of QM will automatically be incorporated into the definition of QRM unless the agencies act to amend the definition of QRM. However, in exercising their responsibility under section 15G, the agencies will evaluate and collectively consider each amendment to QM to decide whether that amendment meets the requirements of section 15G, and take such action, if any, as is required under applicable law, including the Administrative Procedure Act. The agencies note that they will have notice of proposed CFPB changes to the definition of QM and, thus, will be in a position to commence consideration of possible changes to the QM definition before the CFPB issues a final rule. As noted above, section 13(d) of the rule also requires the agencies to conduct periodic reviews of the definition of QRM.

One commenter requested clarification that all QM definitions would be included in the revised QRM definition and there would be full alignment of QRM and QM throughout the life cycle of a loan. As discussed more fully above, QRM is defined to include a loan that meets any of the definitions of QM issued under section 129C of TILA. The agencies also note that the determination of whether a loan meets the QM definition occurs at consummation; post-consummation events that cannot be reasonably anticipated are not relevant.[317]

Some commenters requested revisions to provisions that are set forth in the QM definition, such as the cap on points and fees or the 43 percent DTI ratio limit. The agencies are required to implement the statutory requirement that the definition of QRM be no broader than the definition of a QM, and therefore cannot expand the definition of QRM in this manner.

Some commenters expressed concern with the reproposal to allow higher-priced QMs to be pooled and securitized with non-higher priced QMs. These commenters asserted that higher-priced means higher risk. The commenters asserted, however, that excluding higher-priced QMs from the definition of QRM would unduly restrict LMI access, and in that case, it may be appropriate to treat these loans as QRMs but that the agencies should prohibit their inclusion in securitizations that consisted of non-higher-priced QMs. The requirements for QMs are the same whether they are higher-priced or lower-priced, and those QM criteria are one of the reasons the agencies defined QRM to mean QM. A higher-priced QM under the CFPB's rule must generally meet the 43 percent DTI ratio requirement, have verified income and assets, generally have points and fees that do not exceed the 3 percent cap, have regular periodic payments, and contain no negative amortization, interest only or balloon features (with exceptions for certain small creditors). Accordingly, the final rule does not distinguish between non-higher priced and higher-priced QMs, and both are eligible to be QRMs without distinction, and therefore, can be pooled together in the same securitization.

A few commenters expressed concern that the reproposed QRM definition would still contain in its practical implementation an implicit bias in favor of a single credit scoring brand, FICO, to the exclusion of others. These commenters stated that the Enterprises exclusively use the credit scoring brand FICO when underwriting and determining eligibility of loans for purchase. These commenters claimed that because the QRM definition incorporates the temporary QM definition by reference, which permits loans that are eligible for purchase, guarantee or insurance by an Enterprise to be QRMs (such loans must also still generally meet the general definition of a QM), there is an implicit bias towards the FICO scoring brand. One commenter further asserted that the unintended bias in favor of a single credit scoring brand could be fixed while still ensuring the QM and QRM definitions are aligned by having FHFA require the Enterprises to revise their policies and practices to accept mortgages underwritten with other validated credit scoring models in addition to the single scoring brand currently permitted.

The agencies note that, under the final rule, the definition of QRM is a loan that meets any of the definitions of QM

[314] *See* 12 CFR 1026.43(f).

[315] *See* 12 CFR 1026.43(e)(2), which provides that QM is a covered transaction that meets the criteria set forth in 12 CFR 1026.43(e)(2), (4), (5), (6) or (f). A ''covered transaction'' is defined to mean ''a consumer credit transaction that is secured by a dwelling, as defined in § 1026.2(a)(19), including any real property attached to a dwelling, other than a transaction exempt from coverage under [§ 1026.43(a)].''

[316] The Dodd-Frank Act excludes from the term ''residential mortgage loan'' an open-end credit plan or an extension of credit secured by an interest in a timeshare plan. *See* 15 U.S.C. 1602(cc)(5) and 1639c(i). The Dodd-Frank Act does not apply the ability-to-repay provisions of TILA to reverse mortgages and temporary or ''bridge'' loans with a term of 12 months or less. *See* 15 U.S.C. 1639c(a)(8). Therefore they are also exempt from the ability-to-pay rules. Also excluded are most loan modifications, unless the transaction meets the definition of refinancing set forth in section 1026.20(a) of the Final QM rule. For a complete list, *see* 12 CFR 1026.43(a).

[317] *See* 12 CFR 1026.43(c)(1) and corresponding official staff commentary.

issued under section 129C of TILA. Accordingly, the agencies note that a loan is not required to be eligible for purchase by the Enterprises to meet the definition of QRM.[318] Thus, the agencies do not believe the alignment of the QRM definition with the QM definition includes an implicit bias in favor of a single credit scoring brand as there is no requirement in the QM definition that a consolidated credit score be used or obtained.[319] Therefore, the agencies do not believe that any changes to the QRM definition are needed.

A few commenters expressed concern about the potential bifurcation effect on the market if the definitions of QRM to QM were to be aligned, asserting that a QM/QRM loan may become the only type of residential mortgage made and securitized. Some commenters suggested that the agencies provide flexibility for creditors to continue originating non-QM and non-QRM loans by allowing certain loans to qualify for a lower than 5 percent risk retention requirement. As noted in the reproposal, the agencies recognize that aligning the QRM and QM definitions has the potential to intensify any existing bifurcation in the mortgage market that may occur between QM and non-QM loans, as securitizations collateralized by non-QMs could have higher funding costs due to risk retention requirements in addition to potential risk of legal liability under the ability-to-repay rule. The agencies acknowledge this risk but believe that not aligning the QRM and QM definitions would likely result in even more segmentation in the securitization market and higher costs for consumers. Securitization typically is a more cost-effective source of funding when the underlying pool includes a large number of loans. However, QM and non-QM loans are less likely to be combined in a pool because of the different risk profiles and legal liabilities associated with these loans, and QRM and non-QRM loans cannot be combined in a pool under the restrictions of the rule. Accordingly, if the QRM and QM definitions are not aligned and lenders have difficulty amassing a critical number of loans for an asset pool to provide cost effective funding, they may choose a source of funding other than securitization or charge higher mortgage rates to consumers.

A few other suggestions and concerns expressed by commenters include: (i) a request that the agencies acknowledge that first mortgages secured by real property in priority lien states are encompassed within the QRM definition; (ii) caution that the QRM and credit risk retention rule not evolve into a safety and soundness standard in terms of evaluating an individual lender's real estate portfolio; (iii) a request that the QRM definition reflect the value of Homeownership Education and Counseling in reducing default; and (iv) a request to allow non-U.S. originated transactions to benefit from the QRM exemption. The agencies' definition of QRM is adopted as a component of the broader credit risk retention rule that helps address underwriting and incentive alignment concerns in the securitization market and is not a safety and soundness, standard. The agencies' adoption of the QRM definition does not limit or change the definition of QM and, thus, the application of the definition of QM in priority lien states and to non-U.S. originated transactions is limited by the applicability of the QM definition under TILA and not the adoption of the definition of QRM. Similarly, the agencies are not expressly requiring or including as criteria to meet the QRM definition homeownership education and counseling. The agencies also will evaluate a lender's mortgage portfolio on its own merits and do not expect to judge the safety and soundness of a loan or portfolio on whether or not it meets the definition of QRM.

A few commenters also expressed concern about including subordinate liens in the scope of the QRM definition. These commenters were concerned that permitting subordinate liens to be eligible for the QRM exemption would introduce a layer of additional risk, especially where the QRM definition did not contain a LTV ratio requirement. One commenter specifically requested that the agencies reconsider the inclusion of subordinate lien loans in the definition of QRM, noting that second lien holders have been blamed for holding up short sales and complicating efforts to resolve defaulted loans.

The agencies appreciate these commenters' concerns. However, similar to the reasons discussed in the reproposal, the agencies believe aligning the definition of QRM to the QM definition, which includes loans secured by any dwelling, as well as subordinate liens, is appropriate to minimize potential conflicts between the two definitions. The agencies believe allowing subordinate liens to qualify for the QRM exemption also will help preserve credit access. Last, as noted above, the QM definition requires full documentation and verification of consumers' debt and income on all loans, which the agencies believe helps to address risks that may accompany subordinate liens.

E. Certification and Other QRM Issues

In order for a QRM to be exempted from the risk retention requirement, the rule includes evaluation and certification conditions related to QRM status, consistent with statutory requirements and similar to the reproposal. One commenter requested that the requirement for measuring performance data be as of the cut-off date, and not the closing date. In response to commenters' requests, the agencies have modified the performance measurement date from the closing date to the cut-off date or similar date.

While some commenters supported the proposed certification requirements, others suggested that the certification be submitted to the appropriate Federal banking agency or the Commission, and not to the investors, which the commenters said would create additional liability and be functionally burdensome. One commenter suggested that the agencies make clear that these certifications must be retained by the sponsor for a period of no more than five years.

The agencies believe that the certification by the depositor for the securitization is important information that should be disclosed to investors and therefore are not persuaded by the commenters' requests to require that certification be submitted only to the Commission and the appropriate Federal banking agency, if any.

Several commenters expressed the belief that allowing for blended pools of QRMs and non-QRMs would help ensure that a greater variety of loans could be securitized and reduce market fragmentation between QRMs and non-QRMs. These commenters requested that the agencies permit the blending of non-QRMs and QRMs, with the QRMs being exempt from risk retention and the non-QRMs being subject to risk retention (unless otherwise exempt). Under this approach, the sponsor would be required to hold credit risk in proportion to the non-qualifying assets

[318] Some commenters also called on FHFA to require the Enterprises to apply prime loan criteria in the automatic underwriting system so that the combination of aligning the definitions of QRM and QM and temporary QM definition applicable to loans that qualify for purchase or guarantee by the Enterprises does not cause a decline in underwriting standards and assures high underwriting standards. The agencies view this issue to be outside the scope of this joint rulemaking.

[319] The underwriting requirements under the general QM definition and the small creditor QM definitions do not include a requirement for a credit score or an explicit requirement to consider credit history. However, credit history may be included in underwriting for debt and DTI.

in the pool. These commenters expressed the belief that the exemption authority under section 15G(e)(1) and (2) of the Exchange Act was sufficiently broad to permit the agencies to provide a partial exemption for securitizations collateralized by QRMs and non-QRMs. Another approach suggested was that the agencies permit blending exempt mortgage assets (*e.g.,* seasoned loans) and QRMs, with all such securitized assets remaining exempt from risk retention. Under this approach the sponsor would not be required to hold any credit risk since all of the assets in the pool would qualify for an exemption.

Except as described in Part VII of this Supplementary Information with respect to certain mortgage loans secured by three-to-four unit properties that meet the QM criteria other than being an extension of consumer credit, the agencies are not adopting the requested exemption for blended pools of QRMs and non-QRMs. The agencies believe that the breadth of the QRM definition in the final rule, as well as the additional mortgage exemptions discussed in Part VII of this Supplementary Information, should facilitate the return of private capital to the mortgage market and preserve access to affordable credit for various types of borrowers while the mortgage market continues to stabilize. Furthermore, the agencies observe that differences in product features, underwriting standards, and other factors associated with QRMs and non-QRMs generally could tend to reduce the likelihood of investors preferring combined pools. The agencies also note that a reduction in a risk retention requirement for the pool based on inclusion of QRMs would add complexity to the risk retention regime for residential mortgages without evidence of any significant benefit. Finally, the agencies are concerned, given the breadth of the QRM definition, that allowing reduced risk retention for combined pools of QRMs and non-QRMs will not provide sponsors with sufficient incentives to ensure high quality underwriting of the non-QRM mortgages.[320]

F. Repurchase of Loans Subsequently Determined To Be Non-Qualified After Closing

The reproposal provided that, if after the closing of a QRM securitization transaction, it was discovered that a mortgage did not meet all of the criteria to be a QRM due to inadvertent error, the sponsor would be obligated to repurchase the mortgage.[321] While some commenters expressed support for the proposed requirement, one commenter asserted that investors have historically preferred substitution over repurchase, especially when the required repurchase would impact the value of the investment.

Similar to the reproposal, the final rule includes a buyback requirement for mortgages that are determined not to meet the QRM definition by inadvertent error after the closing of the securitization transaction, provided that the conditions set forth in section 13(c) of the rule are met. These conditions are intended to provide a sponsor with the opportunity to correct inadvertent errors by promptly repurchasing any non-qualifying mortgage loans from the pool. In addition, this requirement helps ensure that sponsors have a strong economic incentive to ensure that all mortgages collateralizing a QRM securitization satisfy all of the conditions applicable to QRMs prior to closing of the transactions. As long as the loan met the QRM requirements at the closing of the securitization transaction, however, subsequent non-performance of the loan does not trigger the proposed buyback requirement. For the reasons described above, the agencies are not allowing substitution instead of repurchase in the final rule.

VII. Additional Exemptions

As discussed in Part VI of this Supplementary Information, under the final rule, a loan is eligible for the QRM exemption if it meets one of the QM definitions issued under section 129C of TILA, as may be amended from time to time. Meeting the QM criteria is also one of several ways that a lender can choose to satisfy the minimum underwriting standards for the ability-to-repay requirements under TILA. Because QM loans may provide greater protection from potential legal liability under TILA, many lenders are incentivized to make QMs.[322]

Community-Focused Lending Exemption

In addition to the classes of transactions exempt from the ability-to-repay requirement under the Dodd-Frank Act, such as HELOCs, reverse mortgages, timeshares or temporary or ''bridge'' loans of 12 months or less, the CFPB exempted certain additional categories of loans made by certain lenders from the ability-to-repay rules, under its regulatory authority to exempt classes of transactions to help ensure borrowers continue to have access to affordable mortgage credit. The CFPB used its regulatory authority to exempt these lenders because they typically use flexible and unique underwriting standards that differ from the minimum underwriting standards of the ability-to-repay or QM criteria, and the types of loans exempted are important sources of credit for LMI, minority and first-time homebuyers.[323] Loans exempt from the ability-to-repay requirement fall into the following categories:

- An extension of credit made pursuant to a program administered by a Housing Finance Agency, as defined under 24 CFR 266.5 (HFA).[324]
- An extension of credit made by an entity creditor designated by the U.S. Treasury as Community Development Financial Institution, as defined under 12 CFR 1805.104(h) (CDFI).
- An extension of credit made by a HUD-designated Downpayment Assistance through Secondary Financing Provider (DAP), pursuant to 24 CFR 200.194(a), operating in accordance with HUD regulations.
- An extension of credit made by a HUD-designated Community Housing Development Organization, as defined under 24 CFR 92.2 (CHDO), provided it has entered into a commitment with a participating jurisdiction and is undertaking a project pursuant to HUD's HOME Investment Partnership Program, pursuant to 24 CFR 92.300(a).
- An extension of credit made by certain non-profit organizations that extend credit no more than 200 times

[320] The agencies are not addressing the permissibility of exempting pools blending QRMs and non-QRMs at this time. The agencies note that section15G of the Exchange Act refers to an exemption from risk retention requirements with respect to an asset-backed security if all the assets that collateralize the asset-backed security are QRMs. *See* 15 U.S.C. 78o–11(c)(1)(C)(iii).

[321] Sponsors may choose to repurchase a loan from securitized pools even if there is no determination that the loan is not a QRM. The agencies would not view such repurchases as determinative of whether or not a loan meets the QRM standard.

[322] HELOCs and timeshares are also not subject to any ATR requirement, but not because of a statutory or regulatory exemption. Rather, these loans were never included in the scope of loans defined to be subject to the ATR requirement (*i.e.,* residential mortgage loans).

[323] *See* 15 U.S.C. 1604(f). *See also* 78 FR 35430 (June 12, 2013).

[324] Housing Finance Agency means any public body, agency, or instrumentality created by a specific act of a State legislature or local municipality empowered to finance activities designed to provide housing and related facilities, through land acquisition, construction or rehabilitation. The term State includes the several States, Puerto Rico, the District of Columbia, Guam, the Trust Territory of the Pacific Islands, American Samoa and the Virgin Islands.

annually,[325] provide credit only to LMI consumers, and follow their own written procedures to determine that consumers have a reasonable ability to repay their loans (Eligible Nonprofits)

• An extension of credit made pursuant to a program authorized by sections 101 and 109 of the Emergency Economic Stabilization Act of 2008 (EESA).[326]

As a result, loans made by these entities do not need to comply with the ability-to-repay requirement, for which QM is one way to comply.

The agencies received several comments regarding some of the above extensions of credit. One commenter requested that the agencies clarify that the proposed exemption from risk retention for asset-backed securities issued or guaranteed by states, municipalities, and public instrumentalities of states (state and municipal securitization exemption)[327] would include asset-backed securities issued by HFAs and other state agencies and collateralized by loans financed by HFAs. This commenter also asked for clarification on whether the use of private servicers in those transactions would affect the availability of the exemption. A few commenters requested that the agencies automatically classify all state HFA loans as QRMs. One commenter observed that the CFPB granted HFA loans an exemption from the ability-to-repay requirement because of a strong record of lending to LMI borrowers, so that compliance with the ability-to-repay requirement would be of little benefit and could impede access to credit by LMI borrowers. Another commenter also asserted that strong credit performance from HFA loans would mean that risk retention is not necessary to protect investors. This commenter further expressed concern that if any HFA loans were subject to risk retention, other securitization structures employed by the HFA that may not technically qualify for the state and municipal securitizations exemption would then be subject to risk retention, with negative consequences for access to credit for underserved borrowers.

Several commenters similarly observed that CDFIs and nonprofit lenders are an important source of mortgage credit for LMI borrowers and play a key role in neighborhood stabilization and community development. These commenters stated that loans made by these entities frequently would not fit the QM criteria because they use flexible underwriting standards that consider an individual borrower's unique circumstances and use homebuyer education and housing counseling to support homeowners throughout the mortgage process. These commenters raised the concern that the risk retention requirement would impose disproportionate compliance burdens on these entities and could be a significant barrier to obtaining investment in these lending programs. Commenters also indicated that exempting these entities from the risk retention requirement would be within the spirit of aligning QRM with QM.

A few other commenters also requested that the agencies similarly consider including under the definition of QRM the other categories of loans exempted by the CFPB from the ability-to-repay rules, or otherwise provide them with an exemption from risk retention. Commenters observed that CDFIs and nonprofit mortgage lenders are an important source of mortgage credit for LMI borrowers and play a key role in neighborhood stabilization and community development. The loans made by these entities are not covered transactions under the ability-to-repay rules (and therefore would not be classified as QMs in any case) but also frequently would not independently meet the type of underwriting standards in the CFPB's QM criteria because they use flexible features that consider an individual borrower's unique circumstances. At the same time, these lenders use homebuyer education and housing counseling to support homeowners throughout the mortgage process. These commenters raised the concern that the risk retention requirements would be a disproportionate compliance burden for these entities and could be a significant barrier to obtaining investment in these lending programs if an exemption was not provided.

Under section 15G of the Securities Act, the definition of a QRM can be ''no broader than'' the definition of a QM. Because there are various and unique underwriting practices used to make the loans described above that are exempted from the ability-to-repay requirement, including significant variations in DTI ratios and other underwriting criteria, it is not possible for the agencies to determine that these loans generally are not ''broader than'' QM. Therefore, the agencies have concluded that they cannot include these community-focused residential mortgages in the definition of QRM.

As discussed previously with respect to other exemptions (or requests for exemptions) from risk retention, however, the agencies may provide an exemption from risk retention if the exemption would: (i) help ensure high-quality underwriting standards for the securitizers and originators of assets that are securitized or available for securitization; and (ii) encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of consumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors.[328]

For the reasons discussed below, and in response to concerns raised by commenters, the agencies are providing an exemption from risk retention under section 15G(e) of the Exchange Act for the categories of loans described above (community-focused exempted loans), other than extensions of credit made pursuant to a program authorized by sections 101 and 109 of the EESA. Generally, the agencies have concluded that the loans made by lenders identified above and covered by this exemption meet the requirements for an exemption under section 15G(e) because they are either government-certified, or originated by government-administered programs, or small non-profit programs that have a specific community mission. As the primary mission of these lenders is building and strengthening at-risk communities, or building wealth for LMI families, strong underwriting procedures to maximize affordability and borrower success in keeping their homes has been integral to the programs that originate the community-focused exempted loans. Because the stated mission is integral to the lending programs administered by these lenders, the agencies believe these entities have the incentive to maintain strong underwriting standards to help ensure that they offer affordable loans to the borrowers they serve. The stated mission also helps to protect investors because of the incentives to maintain high underwriting standards and ensure that borrowers are given appropriate and affordable loans. Additionally, exemptions from risk retention for loans made by the above-listed entities serve the public interest because these entities have stated public mission purposes to make safe, sustainable loans available primarily to LMI communities, which helps to improve access to credit on reasonable terms for borrowers and is in

[325] *See* 79 FR 25730 (May 6, 2014). The CFPB's proposed rule would exclude from the 200 originations count certain forgivable or deferred second lien loans.

[326] 12 U.S.C. 5211; 5219.

[327] 15 U.S.C. 78o–11(c)(1)(G)(iii). *See also* Part IV.B of this Supplementary Information.

[328] 15 U.S.C. 78o–11(e)(2).

the public interest. The agencies further observe that these programs are a significant source of credit to LMI communities. To the extent these loans are or will be securitized, an exemption helps to ensure that a risk retention requirement would not impede financing on reasonable terms for such borrowers.

In addition, the agencies below respond to concerns raised by commenters with respect to the exemption under section 15G of the Exchange Act and the final rule for asset-backed securities issued or guaranteed by states and their instrumentalities, or by municipal entities.

i. Housing Finance Agency Program Loans

State HFAs are state lending programs established to help meet the affordable housing needs of the residents of their states. Although their characteristics vary widely, such as their relationship to the state government, most HFAs are independent entities that operate under the direction of a board of directors appointed by each state's governor. They typically administer a wide range of affordable housing and community development programs, including providing first-time homebuyers with loans for existing and new construction and providing financing to build and revitalize affordable housing units, revitalize older neighborhoods and communities, and build shelters and transitional and supportive housing.

If an HFA is a public instrumentality of a state, then an asset-backed security issued or guaranteed by such HFA (or otherwise issued or guaranteed by the state that established the HFA or one of its public instrumentalities) is exempt from the registration requirements under section 3(a)(2) of the Securities Act [329] and should be exempt from risk retention under the state and municipal securitization exemption provided in section 19(b)(3) of the final rule. Further, the use of a private-sector entity to service loans that collateralize such asset-backed securities would not, in and of itself, invalidate this exemption. If an HFA is not a public instrumentality of a state whose securities are exempt from the registration requirements under section 3(a)(2) of the Securities Act, then securitizations issued or guaranteed by the HFA would not automatically be exempt from risk retention unless another exemption applied. Securitizations of loans made by HFAs through private-sector sponsors also would not have an exemption from risk retention. The agencies understand that it is unclear whether there are any HFA securitizations currently occurring that are not covered under that state and municipal securitizations exemption in section 19(b)(3) of the final rule. However, the agencies believe it may be possible that some future securitizations of HFA loans would not be covered and that an exemption under section 15G(e) of the Exchange Act would help ensure that HFA lending programs continue to have access to the financial markets, which in turn should help to ensure affordable access to credit for the borrowers that they serve.

Many HFA underwriting standards are similarly stringent or more stringent than those of the Enterprises or Federal government agencies thorough their program analyses of a consumer's ability to repay.[330] The agencies believe that an exemption under section 15G(e) would encourage HFAs to continue providing sound underwriting and access to affordable credit for their communities. In addition, as discussed above, the state HFA programs are established under public oversight under a specific state legal framework and provide a key source of affordable mortgage credit for LMI and first-time borrowers that is important to sustaining homeownership (and the public benefits that flow therefrom) in many communities.

ii. Community Development Financial Institution Loans

Creditors designated as CDFIs, as defined under Treasury regulations,[331] include such entities as regulated banks, savings associations and credit unions as well as nonprofit funds and institutions.[332] The Community Development Banking and Financial Institutions Act of 1994,[333] defines a CDFI as an entity that (1) has a primary mission of promoting community development; (2) serves an investment area or targeted population; (3) provides development services in conjunction with equity investments or loans directly or through a subsidiary or affiliate; (4) maintains, through representation on its governing board accountability to residents of its area or target population; and (5) is a nongovernmental entity. Treasury's CDFI certification and application regulations incorporate the statutory definition requirements and contain additional requirements for eligibility verification, applications, matching funds, and other standards. These requirements include that a CDFI must be certified by Treasury's CDFI Fund Program.[334] Additionally, at least 60 percent of the financing activities of a CDFI must be targeted to one or more LMI or underserved communities.

Although CDFI securitization volume data is not available, at least one CDFI, the Community Reinvestment Fund, has issued securitizations in the past. Access to the securitization market for CDFIs may help to ensure that these entities can continue to focus on their mission of providing community development and helping LMI borrowers by preserving access to the securitization market. In determining that these entities warranted an exemption from the ability-to-repay rules, the CFPB found that, although these entities do not have standardized underwriting criteria, they use a variety of compensating factors and compare the strength of different underwriting factors, such as credit history and income, to determine if the LMI consumer qualified.[335] Similar to state HFAs, an exemption from risk retention would assist CDFIs in continuing their mission of providing affordable credit to various communities by allowing them to access securitization markets without risk retention requirements if they were to seek such funding in the future. Furthermore CDFIs have a stated mission requirement to serve the community which requires them to maintain strong underwriting standards to protect the individual borrower and the organization, thus lowering risk for the public and investors.

iii. Community Housing Development Organizations and Downpayment Assistance Programs

To be a CHDO, an organization must qualify under HUD's regulations for such designation and re-qualify every time it receives additional set-asides through the HOME program. HUD's HOME Investment Partnership Program [336] requires the allocation of 15 percent of funds to a CHDO to undergo HOME activities. A CHDO has 5 years to allocate the funds and its activities must be in compliance with both HUD's and the awarding jurisdiction's requirements for use of the HOME

[329] 15 U.S.C. 77c(a)(2).

[330] *See* 78 FR 35430, 35432–33 (June 12, 2013).

[331] 12 CFR 1805.104(h).

[332] There were 874 CDFIs as of June 30, 2014. CDFI Fund, CDFI Certification, visited August 1, 2014, available at: *http://www.cdfifund.gov/what_we_do/programs_id.asp?programID=9#certified.*

[333] 12 U.S.C. 1401 *et seq.*

[334] 12 CFR 1805.201.

[335] 78 FR at 35433, 35461 (June 12, 2013).

[336] There are 353 creditors certified by HUD as CHDOs. OneCPD, HUD Exchange, visited on August 1, 2014, available at: *https://www.onecpd.info/search.*

funds.[337] HUD's requirements for being a CHDO and eligible for an award include: (1) being a private nonprofit organization; (2) having among its purposes the provision of decent housing that is affordable to LMI persons, as evidenced in its charter, articles of incorporation, resolutions or by-laws; (3) having a demonstrated capacity for carrying out housing projects assisted with HOME funds; and (4) having a history of serving the community within which housing to be assisted with HOME funds is to be located. Data indicates that lending at CHDOs totaled $64 million in 2011 with just under 500 loans.[338]

As with CDFIs, although CHDOs do not have standardized underwriting criteria, CHDOs use a variety of compensating factors, including an ability-to-repay analysis,[339] in underwriting mortgage loans to ensure that the loan is appropriate for the borrower.[340] CHDOs use these factors in addition to standard underwriting factors, such as credit history and income, to determine if the LMI consumer qualifies.[341] CHDOs' stated mission to serve LMI persons and requirements to qualify under the HUD program helps to ensure strong, but flexible underwriting of loans to sustain their mission.

For its loans to qualify for an exemption from the ability-to-repay rules, a Downpayment Assistance Provider must operate in accordance with applicable HUD regulations.[342] Consequently, a DAP must be listed on HUD's nonprofit organization roster by applying every two years and specifying the FHA activities it proposes to carry out.[343] The organization must comply with all requirements stated in the specific applicable provision of the single family regulations applicable to the FHA activity it undertakes. Similar to CHDOs, DAPs also use underwriting requirements that are tailored to the target LMI populations.[344] The DAPs' mission requires them to tailor their programs to provide lending for LMI populations, but they must also follow HUD and program-specific requirements which encourage sound lending.

iv. Exempt Nonprofit Organizations

To be exempt from the ability-to-repay rules, a nonprofit organization must have an IRS tax-exempt ruling or determination letter as a 501(c)(3) organization, and meet the following additional criteria:[345] (1) during the preceding calendar year, the organization extended a maximum of 200 dwelling-secured loans;[346] (2) during the preceding calendar year, extended credit only to consumers with income that did not exceed the LMI household limit; (3) the extension of credit must be made to consumers with income that does not exceed the LMI household limit; and (4) the creditor has and uses written procedures to determine the consumer's reasonable ability to repay. Similar to the other categories of lenders exempted from risk retention because of their community-focused lending, as discussed above, these entities serve LMI consumers, and as non-profits, seek to provide borrowers with loans that will be affordable to lower risk to the borrower and the non-profit. Additionally, such entities must maintain a written policy on determining ability to repay for the LMI consumers it serves.

For the reasons discussed above, under section 15G(e) of the Exchange Act, the agencies are exempting from risk retention loans made by the above entities that are also exempt from the ability-to-repay rules under the CFPB's Regulation Z. As discussed above, the agencies have concluded that the history of sound underwriting of affordable mortgage credit to LMI and similar communities by these entities, government oversight and program requirements, as well as the public mission of these entities generally supports findings that these exemptions from risk retention would help ensure high-quality underwriting and be in the public interest and for the protection of investors.

The agencies have not concluded that an exemption is warranted for extensions of credit under EESA programs. Unlike the community-focused lending exemption, the EESA exemption covers special, temporary homeownership stabilization and foreclosure prevention programs that were specially enacted in the wake of the financial crisis to promote the recovery and prevent foreclosures. The EESA programs exempted from the ability-to-repay rule are those authorized under the ''Making Home Affordable'' (MHA) provision and the Hardest Hit Fund (HHF), which includes programs such as the Home Affordable Modification Program and the Home Affordable Foreclosure Alternatives Program. Currently the MHA programs are scheduled to expire on December 31, 2015, and the HHF programs are scheduled to expire on December 31, 2017. The rehabilitative purpose of these programs and their limited duration distinguish these programs from the community-focused lending programs. Consequently, the agencies are not exempting these programs from risk retention.

Under the final rule, an exemption is provided if the asset-backed securities issued in the transaction are collateralized solely by community-focused residential mortgages and by servicing assets. Alternatively, if the community-focused residential mortgages are included in a pool with other non-QRMs, the amount of risk retention required under section 4(a) of the rule is reduced by a ratio of the unpaid principal balance of the community-focused residential mortgages to the total unpaid principal balance of residential mortgages that are included in the pool of assets collateralizing the asset-backed securities issued pursuant to the securitization transaction (the community-focused residential mortgage asset ratio). This community-focused residential mortgage asset ratio must be measured as of the cut-off date or similar date for establishing the composition of the securitized assets collateralizing the asset-backed securities issued pursuant to the securitization transaction. In addition, under the final rule, if the community-focused residential mortgage asset ratio exceeds 50 percent, it is treated as 50 percent, which provides the same ability to pool exempt community-focused residential mortgages with other non-QRMs, as permitted for qualifying and non-qualifying commercial loans, CRE loans, and automobile loans.

Additionally, the agencies are committing in the final rule to review the community-focused lending exemption at the same time the agencies review the QRM definition (*i.e.,* no later than four years after the effective date of this rule with respect to securitizations of residential mortgages, five years after the completion of that initial review, and every five years thereafter.) In addition, the agencies will commence a review of the exemption at any time upon the request of any one of the agencies. This will allow the agencies to

[337] 24 CFR 92.254.

[338] 78 FR at 35434, 35461 (June 12, 2013).

[339] 24 CFR 92.254.

[340] *Id.*

[341] *Id.*

[342] 12 CFR 1026.43(a)(3)(v)(B).

[343] There are currently 205 organizations certified as DAPs. HUD, Nonprofits, visited on August 1, 2014, available at: *https://entp.hud.gov/idapp/html/f17npdata.cfm.*

[344] *See* 78 FR 35430, 35464 (June 12, 2014).

[345] 12 CFR 1026.43(a)(3)(v)(D),

[346] The CFPB has proposed an amendment to exclude from the 200 originations count certain forgivable or deferred second lien loans. *See* 79 FR 25730 (May 6, 2014). Update if CFPB adopts change before this rule is finalized.

assess the advantages and disadvantages of the exemption over time and as the market evolves.

Exemption for Certain Mortgage Loans Secured by Three-to-Four Unit Residential Properties

Under Regulation Z, only loans that are ''covered transactions'' are QMs under the definitions adopted by the CFPB.[347] A ''covered transaction'' under Regulation Z means a consumer credit transaction that is secured by a dwelling (including any real property attached to a dwelling) other than those consumer credit transactions exempted from the ability-to-repay rules by the CFPB.[348] A ''dwelling'' is defined under the CFPB rules as a residential structure that contains one-to-four units (and can include various types of properties such as mobile homes and condominiums).[349] However, the Regulation Z Official Interpretations specify that credit extended to acquire a rental property that is or will be owner-occupied within the coming year and that has more than two housing units is deemed to be for business purposes.[350] In that case, the loan is not a consumer credit transaction or covered transaction under Regulation Z, and therefore does not appear to meet the definition of QM.

In aligning the QRM definition with QM, the agencies understood that covered transactions could include owner-occupied, one-to-four unit residential properties.[351] The agencies also understand that market practice is generally to categorize residential mortgage securitizations as those collateralized by one-to-four unit properties, with mortgages of three-to-four unit properties frequently combined in a single collateral pool with one- or two-unit properties.[352] Enterprise guidelines for residential mortgage securitizations also categorize residential mortgages by one-to-four family units.[353] From a credit risk perspective, mortgages secured by three-to-four unit residential properties generally have the same characteristics as mortgages secured by two-unit properties, which are covered transactions under Regulation Z and may qualify as QMs, and therefore QRMs.

The agencies are concerned that the categorical exclusion of some mortgage loans secured by three-to-four unit mortgages from the definition of ''covered transaction'' under Regulation Z (in accordance with the Official Interpretations) and the consequence that such loans appear not to be QMs even if they otherwise meet all of the other QM criteria, would inappropriately constrain funding from the securitization markets for these types of residential mortgages. This in turn could significantly impact the availability of credit to finance the purchase of such properties by owner-occupiers. While the overall volume of mortgage lending secured by three-to-four unit residential properties is small in relation to all residential mortgage lending, there are some metropolitan areas that contain a significant stock of such properties, including in many low-and-moderate income areas.[354]

At the same time, the agencies believe that owner-occupied, three-to-four unit mortgages that meet the same underwriting qualifications under the QM rule as two unit residential mortgages that meet the QM definition have similar risk characteristics. In order to ensure that such mortgage loans have the same access to securitization markets as similar loans secured by one-to-two unit properties, pursuant to the authority in section 15G(e)(1) of the Exchange Act, the agencies are exempting from risk retention requirements owner-occupied mortgage loans secured by three-to-four unit residential properties that meet all the criteria for QM in Regulation Z except for being a ''consumer credit transaction,'' as determined under Regulation Z and the Official Interpretations. These mortgages are referred to in the final rule as ''qualifying three-to-four unit residential mortgage loans.'' To qualify for the exemption, a mortgage loan secured by a three-to-four unit residential property must be owner-occupied and must comply with all of the requirements for qualified mortgages as set forth in sections 1026.43(e) and (f) of Regulation Z as if the mortgage were a covered transaction for purposes of that section.[355]

The agencies recognize that in order for qualifying three-to-four unit residential mortgage loans to benefit from the exemption from risk retention as intended and maintain access to securitization markets and mortgage credit similar to residential mortgages that are QRMs, it must be possible for sponsors to combine these loans with QRMs in a single collateral pool. Therefore, pursuant to their exemptive authority in section15G (e)(1), the agencies are also providing an exemption from risk retention for securitizations that contain both QRMs and qualifying three-to-four unit residential mortgage loans.

To qualify for these combined pools, the final rule requires that depositors comply with the certification requirements for these exempt securitization transactions on the same basis as qualifying residential mortgage securitization transactions that are exempted from risk retention. That is, the depositor must certify that all the assets in the pool meet either the QRM definition or are qualifying three-to-four unit residential mortgage loans that meet the requirements of section 1026.43(e) (other than being deemed a consumer credit transaction). Additionally, a sponsor must comply with the repurchase requirements for these exempt securitization transactions on the same basis as qualifying residential mortgage securitization transactions that are exempted from risk retention, if it is determined after closing that a loan does not meet all of the criteria to be either a QRM or a qualifying three-to-four unit residential mortgage loan.

As discussed previously with respect to other exemptions from risk retention pursuant to section 15G(e)(1) of the Exchange Act, the agencies may issue exemptions, exceptions or adjustments to the risk retention rules, including for classes of institutions or assets relating to the risk retention requirement, if the exemption would: (i) Help ensure high-

[347] *See* 12 CFR 1026.43(e)(2), (e)(4), (e)(5), and (e)(6).

[348] 12 CFR 1026.43(b)(1).

[349] *See* 12 CFR 1026.2(a)(19).

[350] *See* 12 CFR part 1026 Supplement I, paragraph 3(a)–5.i.

[351] *See,* for example, the discussion in the preamble to the 2013 proposal at 57991 (78 FR 57928, 57991 (September 20, 2013)) and the proposed definition of commercial loan, which excluded any loan to a company or an individual for business purposes to purchase or refinance a one-to-four family residential property (78 FR 57928, 58037 (September 20, 2013)).

[352] *See,* for example, *https://www.americansecuritization.com/uploadedFiles/RMBS%20Outline.pdf*

[353] The agencies also note that other regulations categorize mortgages on one-to-four unit (or family) properties as residential mortgages. See, for example, the definition of ''residential mortgage exposure'' in the banking agency capital regulations (12 CFR 3.2, 12 CFR 217.2; 12 CFR 324.2). *See also* similar definitions in 12 CFR 37.2; 12 CFR part 30, appendix C; 12 CFR part 208, appendix C.

[354] In a review mortgages originated from 2005 to 2013, with respect to each vintage, mortgages collateralized by two-to-four unit properties accounted for between 1 percent and 3 percent of the count of residential mortgages and to one to four percent of the dollar volume (at origination). Data sources reviewed do not generally separately identify one-to-four unit properties. (Data reviewed was from Black Knight Data and Analytics (formerly known as McDash)). It is noted that there are some metropolitan statistical areas across the country in which the share of housing units located in 3 and 4 unit properties is significantly higher than the national average of 4.5 percent, based on data from the U.S. Census, 2013 American Community Survey, 1-year estimates.

[355] 12 CFR 1026.43(e).

quality underwriting standards for the securitizers and originators of assets that are securitized or available for securitization; and (ii) encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of consumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors.[356]

The agencies believe that an exemption from risk retention for securitization transactions collateralized by qualifying three-to-four unit residential mortgage loans and an exemption for combining qualifying three-to-four unit residential mortgage loans and QRMs (as well as servicing assets) in a single securitization pool meets these statutory standards for an exemption under section 15G(e)(1). The exemptions will help ensure high-quality underwriting standards for securitizers and originators of assets that are securitized or available for securitization because all the collateral will have to be mortgage loans secured by owner-occupied, one-to-four family residential properties that met all the requirements to be a QM (other than being deemed a loan for business purposes, and therefore not a covered transaction, under the Official Interpretations of Regulation Z (12 CFR part 1026, Supplement I, paragraph 3(a)(5)(i)). As discussed above with respect to the alignment of the QRM and QM definitions, the agencies believe that the underwriting and product standards for QMs limit credit risk and promote sound underwriting.

The agencies also believe that the exemptions will improve the access of consumers and businesses to credit on reasonable terms because they will help preserve access to securitization funding for mortgage loans to owner-occupied three-to-four unit residential properties on the same basis as other one-to-four unit residential properties. The exemptions are also in the public interest and for the protection of investors because they require all the loans in a securitization transaction that benefit from the exemption to meet the underwriting and product standards of QM, which, for the reasons discussed above in Section VI, appropriately limit credit risk for residential mortgages exempted from risk retention.

The agencies also believe that, because the qualifying three-to-four unit residential mortgage loans will meet all QM criteria other than being a consumer credit transaction, these exemptions are not inconsistent with the provisions of section 15G of the Exchange Act that, absent an exemption, require the agencies to apply risk retention to transactions collateralized by both QRMs and non-QRMs.[357] The agencies have separately retained the exemption mandated in section 15G for risk retention for securitization transactions collateralized solely by QRMs, including the certification requirements also specified in the statute.[358] Moreover, the exemption the agencies are providing for securitizations collateralized by both QRMs and qualifying three-to-four unit residential mortgage loans is limited in scope and only permits the mixing of QRMs and non-QRM loans that are subject to the exact same underwriting and product type standards that limit credit risk and define QM. For these reasons, the agencies are adopting the above described exemption from risk retention in the final rule.

Additionally, the agencies are committing in the final rule to review the exemption for qualifying three-to-four unit residential mortgage loans at the same time the agencies review the QRM definition (*i.e.,* no later than four years after the effective date of this rule with respect to securitizations of residential mortgages, five years after the completion of that initial review, and every five years thereafter.) In addition, the agencies will commence a review of the exemption at any time upon the request of any one of the agencies. This will allow the agencies to assess the advantages and disadvantages of the exemption over time and as the market evolves.

VIII. Severability

If any provision of this rule, or the application thereof to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

IX. Plain Language

Section 722 of the Gramm-Leach-Bliley Act, Public Law 106–102, sec. 722, 113 Stat. 1338, 1471 (Nov. 12, 1999), requires the Federal banking agencies to use plain language in all proposed and final rules published after January 1, 2000. The Federal banking agencies invited comments on how to make the reproposal easier to understand.

X. Administrative Law Matters

A. Regulatory Flexibility Act

OCC: The Regulatory Flexibility Act (RFA) generally requires that, when promulgating a final rule, an agency publish a final regulatory flexibility analysis that describes, among other items, the impact of the final rule on small entities.[359] However, a regulatory flexibility analysis is not required if the head of the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities [360] and publishes the certification and a statement of the factual basis for such certification.[361]

As discussed in the Supplementary Information, the final rule generally requires a securitizer to retain not less than 5 percent of the credit risk of any asset that the securitizer, through the issuance of an asset-backed security (ABS), transfers, sells, or conveys to a third party; and prohibits a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain. In certain situations, the final rule allows securitizers to allocate a portion of the risk retention requirement to the originator(s) of the securitized assets, if an originator contributes at least 20 percent of the assets in the securitization. The final rule also provides an exemption for ABS collateralized exclusively by QRM loans.

In determining whether the final rule would have a significant economic impact on a substantial number of small national banks and Federal savings associations, the OCC reviewed December 31, 2013 Call Report data [362] to evaluate the securitization activity and approximate the number of small banking organizations that potentially could retain credit risk under the final rule primarily through the allocation to originator provisions.

As of December 31, 2013, the OCC regulated approximately 1,231 small national banks and Federal savings associations that would be subject to

[356] 15 U.S.C. 78o–11(e)(1) and (2).

[357] The agencies do not otherwise address the permissibility of exemptions for pools blending QRMs and non-QRMs at this time. *See* note 322, *supra,* and accompanying text.

[358] *See* 15 U.S.C. 78o–11(e)(5) and (e)(6).

[359] 5 U.S.C. 604.

[360] The Small Business Administration defines small entity to include national banks or Federal savings associations with assets of $550 million or less. 13 CFR 121.201.

[361] 5 U.S.C. 605(b).

[362] Call Report Schedule RC–S provides information on the servicing, securitization, and asset sale activities of banking organizations. For purposes of the RFA analysis, the OCC evaluated data regarding residential mortgage loan origination for securitization, as this is the primary securitization activity by small banking organizations.

this rule. The Call Report data indicates that approximately 155 small national banks and Federal savings associations originate loans for securitization, predominantly one-to-four family residential mortgages. Using a threshold of 5 percent of small regulated institutions, the final rule could impact a substantial number of small national banks and Federal savings associations.

The vast majority of securitization activity by small banks is in the residential mortgage sector. Many of these banks originate and sell residential mortgage loans to the Enterprises, which satisfy risk retention under the final rule when they securitize those loans and would not allocate risk retention to the originating banks under the final rule. Small banks that originate mortgages for securitization through other channels likely would be exempt from risk retention by another provision in the rule, such as that the loans meet the QRM definition or meet the community focused lending securitization exemption. For these reasons, the OCC concludes that the final rule would not have a significant economic impact on a substantial number of small national banks and Federal savings associations.[363]

Board: In general, section 4 of the Regulatory Flexibility Act (5 U.S.C. 604) requires an agency to prepare a final regulatory flexibility analysis for a final rule unless the agency certifies that the rule will not, if promulgated, have a significant economic impact on a substantial number of small entities (defined as of July 14, 2014, to include banking entities with total assets of $550 million or less) (''small banking entities'').[364] Pursuant to section 505(b) of the Regulatory Flexibility Act, a final regulatory flexibility analysis is not required if an agency certifies that the final rule will not have a significant economic impact on a substantial number of small entities. The Board has considered the potential economic impact of the final rule on small banking entities supervised by the Board in accordance with the Regulatory Flexibility Act. The Board believes that the final rule will not have a significant economic impact on a substantial number of small banking entities supervised by the Board for the reasons described below.

For the reasons discussed in Part II of this Supplementary Information, the final rule defines a securitizer as a ''sponsor'' in a manner consistent with the definition of that term in the Commission's Regulation AB and provides that the sponsor of a securitization transaction is generally responsible for complying with the risk retention requirements established under section 15G. The Board is unaware of any small banking organization under the supervision of the Board that has acted as a sponsor of a securitization transaction[365] (based on December 31, 2013 data).[366] As of December 31, 2013, there were approximately 5,051 small banking organizations supervised by the Board, which includes 4,009 bank holding companies, 298 savings and loan holding companies, 651 state member banks, 23 Edge and agreement corporations and 70 U.S. offices of foreign banking organizations.

The final rule permits, but does not require, a sponsor to allocate a portion of its risk retention requirement to one or more originators of the securitized assets, subject to certain conditions being met. In particular, a sponsor may offset the risk retention requirement by the amount of any eligible vertical risk retention interest or eligible horizontal residual interest acquired by an originator of one or more securitized assets if certain requirements are satisfied, including, the originator must originate at least 20 percent of the securitized assets.[367] A sponsor using this risk retention option remains responsible for ensuring that the originator has satisfied the risk retention requirements. In light of this option, the Board has considered the impact of the final rule on originators that are small banking organizations.

The December 31, 2013 regulatory report data[368] indicates that approximately 757 small banking organizations, 102 of which are small banking organizations that are supervised by the Board, originate loans for securitization, namely ABS issuances collateralized by one-to-four family residential mortgages. The majority of these originators sell their loans to the Enterprises, which retain credit risk through agency guarantees and would not be able to allocate credit risk to originators under this proposed rule. Additionally, based on publicly-available market data, it appears that most residential mortgage-backed securities offerings are collateralized by a pool of mortgages with an unpaid aggregate principal balance of at least $500 million.[369] Accordingly, under the final rule a sponsor could potentially allocate a portion of the risk retention requirement to a small banking organization only if such organization originated at least 20 percent ($100 million) of the securitized mortgages. As of December 31, 2012, only one small banking organization supervised by the Board reported an outstanding principal balance of assets sold and securitized of $100 million or more.[370]

For residential mortgage-backed securitizations, the draft final rule is expected to have minimal impact on the cost of credit for sponsors of non-Enterprise mortgage-backed securitizations that currently retain less than the draft final rule's base risk retention requirement. The markets for those residential mortgages exempted under the draft final rule should be very large, and result in significant liquidity, economies of scale, little to no impact for these securitizations.

[363] The OCC previously concluded that the reproposed rule, if finalized, would not have a significant economic impact on a substantial number of small national banks and Federal savings associations. *See* Section VIII.A, 78 FR 57928 (September 20, 2013). The OCC requested comment and received no responsive comments on that conclusion.

[364] *See* 13 CFR 121.201; *See also* 13 CFR 121.103(a)(6) (noting factors that the Small Business Administration considers in determining whether an entity qualifies as a small business, including receipts, employees, and other measures of its domestic and foreign affiliates).

[365] For purposes of the proposed rules, this would include a small bank holding company; savings and loan holding company; state member bank; Edge corporation; agreement corporation; foreign banking organization; and any subsidiary of the foregoing.

[366] Call Report Schedule RC–S; Data based on the Reporting Form FR 2866b; Structure Data for the U.S. Offices of Foreign Banking Organizations; and Aggregate Data on Assets and Liabilities of U.S. Branches and agencies of Foreign Banks based on the quarterly form FFIEC 002.

[367] With respect to an open market CLO transaction, the risk retention retained by the originator must be at least 20 percent of the aggregate principal balance at origination of a CLO-eligible loan tranche.

[368] Call Report Schedule RC–S provides information on the servicing, securitization, and asset sale activities of banking organizations. For purposes of the RFA analysis, the agencies gathered and evaluated data regarding (1) the outstanding principal balance of assets sold and securitized by the reporting entity with servicing retained or with recourse or other seller-provided credit enhancements, and (2) assets sold with recourse or other seller-provided credit enhancements and not securitized by the reporting bank.

[369] Based on the data provided in Table 1, page 29 of the Board's ''Report to the Congress on Risk Retention'', it appears that the average MBS issuance is collateralized by a pool of approximately $620 million in mortgage loans (for prime MBS issuances) or approximately $690 million in mortgage loans (for subprime MBS issuances). For purposes of the RFA analysis, the agencies used an average asset pool size of $500 million to account for reductions in mortgage securitization activity following 2007, and to add an element of conservatism to the analysis.

[370] The FDIC notes that this finding assumes that no portion of the assets originated by small banking organizations were sold to securitizations that qualify for an exemption from the risk retention requirements under the proposed rule.

Commercial loans that have in recent years been securitized through open market CLOs may experience a modest incremental impact in the cost of credit, as mangers of open market CLOs increase their credit exposure to 5 percent using the horizontal risk retention option under the draft final rule. There could also be consolidation in the asset manager industry as a result. The alternative option for lead arrangers to hold risk in the final rule should have minimal impact on the cost of credit (approximately 0–10 basis points) because it would be a vertical interest. An estimate for the incremental increase in the cost of credit for CLO managers is approximately 10–20 basis points, but because risk retention would affect the current business model, costs may be higher than expected.

The draft final rule will also likely have an effect on CMBS transactions. The typical market practice of holding horizontal risk retention of 2.5 percent for conduit transactions will double to 5 percent under the draft rule. The Board estimates that the rule will have a small incremental impact on cost of credit (of up to 10 basis points, approximately) for sponsors subject to the rule, but reducing the leverage of third-party purchasers could significantly improve issuer incentives, and other requirements in the rule could mitigate existing conflicts of interest between third-party purchasers and sponsors who hold residual interests and senior investors. Single-Borrower CMBS, despite a lack of current risk retention in practice, should experience a modest incremental impact on cost of credit (of up to approximately 25 basis points). The rule should have little to no effect on the cost of credit for credit card, prime and non-prime auto, student loan, and less common (esoteric) securitizations, because the amount of credit risk retention typical to these securitizations already being held in the market is generally adequate to satisfy the requirements in the final rule.

In light of the foregoing, the Board does not believe, for the banking entities subject to the Board's jurisdiction, that the final rule would have a significant economic impact on a substantial number of small entities.

FDIC: The Regulatory Flexibility Act, 5 U.S.C. 601 *et seq.* (RFA), requires an agency, in connection with a final rule, to prepare a Final Regulatory Flexibility Act analysis describing the impact of the rule on small entities (defined by the Small Business Administration for purposes of the RFA to include banking entities with total assets of $550 million or less) or to certify that the rule will not have a significant economic impact on a substantial number of small entities.[371]

As of June 30, 2014, there were 3,573 small FDIC-supervised institutions, which include 3,267 state nonmember banks and 306 state-chartered savings institutions. For the reasons provided below, the FDIC certifies that the final rule will not have a significant economic impact on a substantial number of small entities, which in this context are small banking organizations supervised by the FDIC with total assets of $550 million or less. Accordingly, a regulatory flexibility analysis is not required.

As discussed in the Supplementary Information above, section 941 of the Dodd-Frank Act[372] generally requires the Federal banking agencies and the Commission, and, in the case of the securitization of any residential mortgage asset, together with HUD and FHFA, to jointly prescribe regulations, that (i) require a securitizer to retain not less than 5 percent of the credit risk of any asset that the securitizer, through the issuance of an asset-backed security (ABS), transfers, sells, or conveys to a third party; and (ii) prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain under section 15G. Although the final rule will apply directly only to securitizers, subject to certain considerations section 15G authorizes the agencies to permit securitizers to allocate at least a portion of the risk retention requirement to the originator(s) of the securitized assets.

Section 15G provides a total exemption from the risk retention requirements for securitizers of certain securitization transactions, such as an ABS issuance collateralized exclusively by QRMs, and further authorizes the agencies to establish a lower risk retention requirement for securitizers of ABS issuances collateralized by other asset types, such as commercial, commercial real estate (CRE), and automobile loans, which satisfy underwriting standards established by the Federal banking agencies and the Commission. The risk retention requirements of section 15G apply generally to a ''securitizer'' of ABS, where securitizer is defined to mean (i) an issuer of an ABS; or (ii) a person who organizes and initiates an asset-backed transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer. Section 15G also defines an ''originator'' as a person who (i) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and (ii) sells an asset directly or indirectly to a securitizer. The final rule implements the credit risk retention requirements of section 15G. The final rule, as a general matter, requires that a ''sponsor'' of a securitization transaction retain the credit risk of the securitized assets in the form and amount required by the final rule. The agencies believe that imposing the risk retention requirement on the sponsor of the ABS—as permitted by section 15G—is appropriate in view of the active and direct role that a sponsor typically has in arranging a securitization transaction and selecting the assets to be securitized. The FDIC is aware of only 22 small banking organizations that currently sponsor securitizations (three of which are national banks, eight of which are state member banks, eight of which are state nonmember banks, and three of which are savings associations, based on June 30, 2014 information) and, therefore, the risk retention requirements of the final rule, as generally applicable to sponsors, will not have a significant economic impact on small banking organizations. Under the final rule a sponsor may offset the risk retention requirement by the amount of any eligible vertical interest or eligible horizontal residual interest acquired by an originator of one or more securitized assets if certain requirements are satisfied, including, the originator must originate at least 20 percent of the securitized assets, as measured by the aggregate unpaid principal balance of the asset pool.[373] In determining whether the allocation provisions of the final rule will have a significant economic impact on a substantial number of small banking organizations, the Federal banking agencies reviewed June 30, 2014, consolidated reports of condition and income (''Call Report'') data to evaluate the securitization activity and approximate the number of small banking organizations that potentially could retain credit risk under allocation provisions of the final rule.[374] As of

[371] *See* 5 U.S.C. 601 *et seq.*

[372] Codified at section 15G of the Exchange Act, 17 U.S.C. 78o–11.

[373] With respect to an open market CLO transaction, the risk retention retained by the originator must be at least 20 percent of the aggregate principal balance at origination of a CLO-eligible loan tranche.

[374] Call Report Schedule RC–S provides information on the servicing, securitization, and asset sale activities of banking organizations. For purposes of the RFA analysis, the agencies gathered and evaluated data regarding (1) the outstanding principal balance of assets sold and securitized by the reporting entity with servicing retained or with recourse or other seller-provided credit

June 30, 2014, the Call Report data indicates that approximately 763 small banking organizations, 493 of which are state nonmember banks, originate loans for securitization which are largely ABS issuances collateralized by one-to-four family residential mortgages. Many of these originators sell their loans either to Fannie Mae or Freddie Mac, which retain credit risk through agency guarantees, and therefore will not be allocated credit risk under the final rule. Additionally, based on publicly available market data, it appears that most residential mortgage-backed securities offerings are collateralized by a pool of mortgages with an unpaid aggregate principal balance of at least $500 million.[375] Accordingly, under the final rule a sponsor could potentially allocate a portion of the risk retention requirement to a small banking organization only if such organization originated at least 20 percent ($100 million) of the securitized mortgages. As of June 30, 2014, only nine small banking organizations supervised by the FDIC reported an outstanding principal balance of assets sold and not securitized by the reporting bank of $100 million or more.[376]

Therefore, the FDIC does not believe that the final rule will result in a significant economic impact on a substantial number of small banking organizations under its supervisory jurisdiction. The FDIC certifies that the final rule will not have a significant economic impact on a substantial number of small FDIC-supervised institutions.

Commission: The Regulatory Flexibility Act of 1980 requires the Commission, in promulgating rules, to consider the impact of those rules on small entities. An initial Regulatory Flexibility Act Analysis was prepared in accordance with the Regulatory Flexibility Act and included in the re-proposing release. The Commission certified in the re-proposing release, pursuant to 5 U.S.C. 605(b), that the proposed rule, if adopted, would not have a significant economic impact on a substantial number of small entities. The Commission received one comment[377] on this certification.

The final rule implements the risk retention requirements of section 15G of the Exchange Act, which, in general, requires the securitizer of asset-backed securities (ABS) to retain not less than 5 percent of the credit risk of the assets collateralizing the ABS.[378] Under the final rule, the risk retention requirements apply to ''sponsors'', as defined in the final rule. Based on the analysis set forth in the original proposal and the reproposal, the Commission continues to believe that the final rule would not have a significant economic impact on a substantial number of small entities.

Some commenters on the re-proposal expressed concern that the re-proposed risk retention requirements could indirectly affect the costs and availability of credit to small businesses and the availability of mortgage credit to low- to moderate-income buyers. The Regulatory Flexibility Act only requires an agency to consider regulatory alternatives for those small entities subject to the final rule. The Commission has considered the broader economic impact of the final rule, including their potential effect on efficiency, competition and capital formation, in the Commission's Economic Analysis below.

For the reasons described above, the Commission again hereby certifies, pursuant to 5 U.S.C. 605(b), that the final rule will not have a significant economic impact on a substantial number of small entities.

FHFA: FHFA has considered the impact of the final rule on the entities that it regulates, none of which come within the meaning of small entities as defined in the Regulatory Flexibility Act (RFA). *See* 5 U.S.C. 601(6). Pursuant to section 605(b) of the RFA, FHFA hereby certifies that the final rule will not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act

1. Background

Certain provisions of the final rule contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (''PRA''), 44 U.S.C. 3501–3521. In accordance with the requirements of the PRA, the agencies may not conduct or sponsor, and the respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number. The agencies published a notice requesting comment on the collection of information requirements in the Original Proposal and the Revised Proposal, and the information collection requirements contained in this joint final rule have been submitted by the FDIC, OCC, and the Commission to OMB for approval under section 3507(d) of the PRA and section 1320.11 of OMB's implementing regulations (5 CFR part 1320). The Board reviewed the rule under the authority delegated to the Board by OMB. While commenters provided qualitative comments on the possible costs of the rule, the agencies did not receive any quantitative comments on the PRA analysis.

2. Information Collection

Title of Information Collection: Credit Risk Retention.

Frequency of response: Event generated; annual.

Affected Public:[379]

FDIC: Insured state non-member banks, insured state branches of foreign banks, state savings associations, and certain subsidiaries of these entities.

OCC: National banks, Federal savings associations, Federal branches or agencies of foreign banks, or any operating subsidiary thereof.

Board: Insured state member banks, bank holding companies, savings and loan holding companies, Edge and agreement corporations, foreign banking organizations, nonbank financial companies supervised by the Board, and any subsidiary thereof.

Commission: All entities other than those assigned to the FDIC, OCC, or Board.

Abstract: The rule sets forth permissible forms of risk retention for securitizations that involve issuance of asset-backed securities, as well as exemptions from the risk retention requirements, and contains requirements subject to the PRA. The information requirements in the joint regulations adopted by the three Federal banking agencies and the Commission

enhancements, and (2) assets sold with recourse or other seller-provided credit enhancements and not securitized by the reporting bank.

[375] Based on the data provided in Table 1, page 29 of the Board's October 2010 Report covering 2002 through 2010 entitled, ''Report to the Congress on Risk Retention,'' it appears that the average RMBS issuance is collateralized by a pool of approximately $620 million in mortgage loans (for prime RMBS issuances) or approximately $690 million in mortgage loans (for subprime RMBS issuances). For purposes of the RFA analysis, the agencies used an average asset pool size of $500 million to account for reductions in mortgage securitization activity following 2007, and to add an element of conservatism to the analysis.

[376] The FDIC notes that this finding assumes that all assets originated by small banking organizations reported on RC–S as being sold, whether or not securitized by the reporting bank, would be subject to the 5 percent risk retention requirement (and would not qualify for an exemption from the risk retention requirements under the final rule).

[377] One commenter urged the agencies to develop the required Regulatory Flexibility Act analysis to accurately assess the impact on small entities of the QM-plus approach to define QRM, if the agencies adopt such approach. The agencies are not adopting the QM-plus approach to define QRM.

[378] *See* 17 U.S.C. 78o–11.

[379] The affected public of the FDIC, OCC, and Board is assigned generally in accordance with the entities covered by the scope and authority section of their respective rule. The affected public of the Commission is based on those entities not already accounted for by the FDIC, OCC, and Board.

are found in sections __.4, __.5, __.6, __.7, __.8, __.9, __.10, __.11, __.13, __.15, __.16, __.17, __.18, and __.19(g). The agencies believe that the disclosure and recordkeeping requirements associated with the various forms of risk retention will enhance market discipline, help ensure the quality of the assets underlying a securitization transaction, and assist investors in evaluating transactions. Compliance with the information collections is mandatory. Responses to the information collections will not be kept confidential and, except for the recordkeeping requirements set forth in sections __.4(d), __.5(k)(3) and __.15(d), there will be no mandatory retention period for the collections of information.

3. Section-by-Section Analysis

Section __.4 sets forth the conditions that must be met by sponsors electing to use the standard risk retention option, which may consist of an eligible vertical interest or an eligible horizontal residual interest, or any combination thereof. Sections __.4(c)(1) and __.4(c)(2) specify the disclosures required with respect to eligible horizontal residual interests and eligible vertical interests, respectively.

A sponsor retaining any eligible horizontal residual interest (or funding a horizontal cash reserve account) is required to disclose: The fair value (or a range of fair values and the method used to determine such range) of the eligible horizontal residual interest that the sponsor expects to retain at the closing of the securitization transaction (§ __.4(c)(1)(i)(A)); the material terms of the eligible horizontal residual interest (§ __.4(c)(1)(i)(B)); the methodology used to calculate the fair value (or range of fair values) of all classes of ABS interests (§ __.4(c)(1)(i)(C)); the key inputs and assumptions used in measuring the estimated total fair value (or range of fair values) of all classes of ABS interests (§ __.4(c)(1)(i)(D)); the reference data set or other historical information used to develop the key inputs and assumptions (§ __.4(c)(1)(i)(G)); the fair value of the eligible horizontal residual interest retained by the sponsor (§ __.4(c)(1)(ii)(A)); the fair value of the eligible horizontal residual interest required to be retained by the sponsor (§ __.4(c)(1)(ii)(B)); description of any material differences between the methodology used in calculating the fair value disclosed prior to sale and the methodology used to calculate the fair value at the time of closing (§ __.4(c)(1)(ii)(C)); and the amount placed by the sponsor in the horizontal cash reserve account at closing, the fair value of the eligible horizontal residual interest that the sponsor is required to fund through such account, and a description of such account (§ __.4(c)(1)(iii)).

For eligible vertical interests, the sponsor is required to disclose: The form of the eligible vertical interest (§ __.4(c)(2)(i)(A)); the percentage that the sponsor is required to retain (§ __.4(c)(2)(i)(B)); a description of the material terms of the vertical interest and the amount the sponsor expects to retain at closing (§ __.4(c)(2)(i)(C)); and the amount of vertical interest retained by the sponsor at closing ((§ __.4(c)(2)(ii)).

Section __.4(d) requires a sponsor to retain the certifications and disclosures required in paragraphs (a) and (c) of this section in its records and must provide the disclosure upon request to the Commission and the sponsor's appropriate Federal banking agency, if any, until three years after no ABS interests are outstanding.

Section __.5 requires sponsors relying on the master trust (or revolving pool securitization) risk retention option to disclose: The material terms of the seller's interest and the percentage of the seller's interest that the sponsor expects to retain at the closing of the transaction (§ __.5(k)(1)(i)); the percentage of the seller's interest that the sponsor retained at closing (§ __.5(k)(1)(ii)); the material terms of any horizontal risk retention offsetting the seller's interest under § __.5(g), § __.5(h) and § __.5(i) (§ __.5(k)(1)(iii)); and the fair value of any horizontal risk retention retained by the sponsor (§ __.5(k)(1)(iv)). Additionally, a sponsor must retain the disclosures required in § __.5(k)(1) in its records and must provide the disclosure upon request to the Commission and the sponsor's appropriate Federal banking agency, if any, until three years after no ABS interests are outstanding (§ __.5(k)(3)).

Section __.6 addresses the requirements for sponsors utilizing the eligible ABCP conduit risk retention option. The requirements for the eligible ABCP conduit risk retention option include disclosure to each purchaser of ABCP and periodically to each holder of commercial paper issued by the ABCP conduit of the name and form of organization of the regulated liquidity provider that provides liquidity coverage to the eligible ABCP conduit, including a description of the material terms of such liquidity coverage, and notice of any failure to fund; and with respect to each ABS interest held by the ABCP conduit, the asset class or brief description of the underlying securitized assets, the standard industrial category code for each originator-seller that retains an interest in the securitization transaction, and a description of the percentage amount and form of interest retained by each originator-seller (§ __.6(d)(1)). An ABCP conduit sponsor relying upon this section shall provide, upon request, to the Commission and the sponsor's appropriate Federal banking agency, if any, the information required under § __.6(d)(1), in addition to the name and form of organization of each originator-seller that retains an interest in the securitization transaction (§ __.6(d)(2)).

A sponsor relying on the eligible ABCP conduit risk retention option shall maintain and adhere to policies and procedures to monitor compliance by each originator-seller (§ __.6(f)(2)(i)). If the ABCP conduit sponsor determines that an originator-seller is no longer in compliance, the sponsor must promptly notify the holders of the ABCP, and upon request, the Commission and the sponsor's appropriate Federal banking agency, in writing of the name and form of organization of any originator-seller that fails to retain, and the amount of ABS interests issued by an intermediate SPV of such originator-seller and held by the ABCP conduit (§ __.6(f)(2)(ii)(A)(1)); the name and form of organization of any originator-seller that hedges, directly or indirectly through an intermediate SPV, its risk retention in violation of the rule, and the amount of ABS interests issued by an intermediate SPV of such originator-seller and held by the ABCP conduit (§ __.6(f)(2)(ii)(A)(2)); and any remedial actions taken by the ABCP conduit sponsor or other party with respect to such ABS interests (§ __.6(f)(2)(ii)(A)(3)).

Section __.7 sets forth the requirements for sponsors relying on the commercial mortgage-backed securities risk retention option, and includes disclosures of: The name and form of organization of each initial third-party purchaser (§ __.7(b)(7)(i)); each initial third-party purchaser's experience in investing in commercial mortgage-backed securities (§ __.7(b)(7)(ii)); other material information (§ __.7(b)(7)(iii)); the fair value and purchase price of the eligible horizontal residual interest retained by each third-party purchaser, and the fair value of the eligible horizontal residual interest that the sponsor would have retained if the sponsor had relied on retaining an eligible horizontal residual interest under the standard risk retention option (§ __.7(b)(7)(iv) and (v)); a description of the material terms of the eligible horizontal residual interest retained by each initial third-party purchaser, including the same information as is

required to be disclosed by sponsors retaining horizontal interests pursuant to § __.4 (§ __.7(b)(7)(vi)); the material terms of the applicable transaction documents with respect to the Operating Advisor (§ __.7(b)(7)(vii)); and representations and warranties concerning the securitized assets, a schedule of any securitized assets that are determined not to comply with such representations and warranties, and the factors used to determine that such securitized assets should be included in the pool notwithstanding that they did not comply with the representations and warranties (§ __.7(b)(7)(viii)). A sponsor relying on the commercial mortgage-backed securities risk retention option is also required to provide in the underlying securitization transaction documents certain provisions related to the Operating Advisor (§ __.7(b)(6)), to maintain and adhere to policies and procedures to monitor compliance by third-party purchasers with regulatory requirements (§ __.7(c)(2)(A)), and to notify the holders of the ABS interests in the event of noncompliance by a third-party purchaser with such regulatory requirements (§ __.7(c)(2)(B)).

Section __.8 requires that a sponsor relying on the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation risk retention option must disclose a description of the manner in which it has met the credit risk retention requirements (§ __.8(c)).

Section __.9 sets forth the requirements for sponsors relying on the open market CLO risk retention option, and includes disclosures of a complete list of, and certain information related to, every asset held by an open market CLO (§ __.9(d)(1)), and the full legal name and form of organization of the CLO manager (§ __.9(d)(2)).

Section __.10 sets forth the requirements for sponsors relying on the qualified tender option bond risk retention option, and includes disclosures of the name and form of organization of the qualified tender option bond entity, a description of the form and subordination features of the retained interest in accordance with the disclosure obligations in section __.4(d), the fair value of any portion of the retained interest that is claimed by the sponsor as an eligible horizontal residual interest, and the percentage of ABS interests issued that is represented by any portion of the retained interest that is claimed by the sponsor as an eligible vertical interest (§ __.10(e)(1)–(4)). In addition, to the extent any portion of the retained interest claimed by the sponsor is a municipal security held outside of the qualified tender option bond entity, the sponsor must disclose the name and form of organization of the qualified tender option bond entity, the identity of the issuer of the municipal securities, the face value of the municipal securities deposited into the qualified tender option bond entity, and the face value of the municipal securities retained outside of the qualified tender option bond entity by the sponsor or its majority-owned affiliates (§ __.10(e)(5)).

Section __.11 sets forth the conditions that apply when the sponsor of a securitization allocates to originators of securitized assets a portion of the credit risk the sponsor is required to retain, including disclosure of the name and form of organization of any originator that acquires and retains an interest in the transaction, a description of the form, amount and nature of such interest, and the method of payment for such interest (§ __.11(a)(2)). A sponsor relying on this section is required to maintain and adhere to policies and procedures that are reasonably designed to monitor originator compliance with retention amount and hedging, transferring and pledging requirements (§ __.11(b)(2)(A)), and to promptly notify the holders of the ABS interests in the transaction in the event of originator non-compliance with such regulatory requirements (§ __.11(b)(2)(B)).

Sections __.13 and __.19(g) provide exemptions from the risk retention requirements for qualified residential mortgages and qualifying 3-to-4 unit residential mortgage loans that meet certain specified criteria, including that the depositor with respect to the securitization transaction certify that it has evaluated the effectiveness of its internal supervisory controls and concluded that the controls are effective (§§ __.13(b)(4)(i) and __.19(g)(2)), and that the sponsor provide a copy of the certification to potential investors prior to sale of asset-backed securities in the issuing entity (§§ __.13(b)(4)(iii) and __.19(g)(2)). In addition, §§ __.13(c)(3) and __.19(g)(3) provide that a sponsor that has relied upon the exemptions will not lose the exemptions if, after closing of the transaction, it is determined that one or more of the residential mortgage loans does not meet all of the criteria; provided that the depositor complies with certain specified requirements, including prompt notice to the holders of the asset-backed securities of any loan that is required to be repurchased by the sponsor, the amount of such repurchased loan, and the cause for such repurchase.

Section __.15 provides exemptions from the risk retention requirements for qualifying commercial loans that meet the criteria specified in Section __.16, qualifying CRE loans that meet the criteria specified in Section __.17, and qualifying automobile loans that meet the criteria specified in Section __.18. Section __.15 also requires the sponsor to disclose a description of the manner in which the sponsor determined the aggregate risk retention requirement for the securitization transaction after including qualifying commercial loans, qualifying CRE loans, or qualifying automobile loans with 0 percent risk retention (§ __.15(a)(4)). In addition, the sponsor is required to disclose descriptions of the qualifying commercial loans, qualifying CRE loans, and qualifying automobile loans (''qualifying assets''), and descriptions of the assets that are not qualifying assets, and the material differences between the group of qualifying assets and the group of assets that are not qualifying assets with respect to the composition of each group's loan balances, loan terms, interest rates, borrower credit information, and characteristics of any loan collateral (§ __.15(b)(3)). Additionally, a sponsor must retain the disclosures required in §§ __.15(a) and (b) in its records and must provide the disclosure upon request to the Commission and the sponsor's appropriate Federal banking agency, if any, until three years after no ABS interests are outstanding (§ __.15(d)).

Sections __.16, __.17 and __.18 each require that: The depositor of the asset-backed security certify that it has evaluated the effectiveness of its internal supervisory controls and concluded that its internal supervisory controls are effective (§§ __.16(a)(8)(i), __.17(a)(10)(i), and __.18(a)(8)(i)); the sponsor is required to provide a copy of the certification to potential investors prior to the sale of asset-backed securities in the issuing entity (§§ __.16(a)(8)(iii), __.17(a)(10)(iii), and __.18(a)(8)(iii)); and the sponsor must promptly notify the holders of the asset-backed securities of any loan included in the transaction that is required to be cured or repurchased by the sponsor, including the principal amount of such loan and the cause for such cure or repurchase (§§ __.16(b)(3), __.17(b)(3), and __.18(b)(3)). Additionally, a sponsor must retain the disclosures required in §§ __.16(a)(8), __.17(a)(10) and __.18(a)(8) in its records and must provide the disclosure upon request to the Commission and the sponsor's appropriate Federal banking agency, if any, until three years after no ABS interests are outstanding (§ __.15(d)).

4. Estimated Paperwork Burden

Estimated Burden per Response:

§ __.4—Standard risk retention: horizontal interests: recordkeeping—0.5 hours, disclosures—5.5 hours; vertical interests: recordkeeping—0.5 hours, disclosures—2.0 hours; combined horizontal and vertical interests: recordkeeping—0.5 hours, disclosures—7.5 hours.

§ __.5—Revolving master trusts: recordkeeping—0.5 hours; disclosures—7.0 hours.

§ __.6—Eligible BCP conduits: recordkeeping—20.0 hours; disclosures—3.0 hours.

§ __.7—Commercial mortgage-backed securities: recordkeeping—30.0 hours; disclosures—20.75 hours.

§ __.8—Federal National Mortgage Association and Federal Home Loan Mortgage Corporation ABS: disclosures—1.5 hours.

§ __.9—Open market CLOs: disclosures—20.25 hours.

§ __.10—Qualified tender option bonds: disclosures—6.0 hours.

§ __.11—Allocation of risk retention to an originator: recordkeeping 20.0 hours; disclosures 2.5 hours.

§§ __.13 and __.19(g)—Exemption for qualified residential mortgages and qualifying 3-to-4 unit residential mortgage loans: recordkeeping—40.0 hours; disclosures 1.25 hours.

§ __.15—Exemption for qualifying commercial loans, commercial real estate loans, and automobile loans: disclosure—20.0 hours; recordkeeping—0.5 hour.

§ __.16—Underwriting standards for qualifying commercial loans: recordkeeping—40.5 hours; disclosures—1.25 hours.

§ __.17— Underwriting standards for qualifying CRE loans: recordkeeping—40.5 hours; disclosures—1.25 hours.

§ __.18—Underwriting standards for qualifying automobile loans: recordkeeping—40.5 hours; disclosures—1.25 hours.

FDIC

Estimated Number of Respondents: 32 sponsors; 153 annual offerings per year.

Total Estimated Annual Burden: 3,235 hours.

OCC

Estimated Number of Respondents: 35 sponsors; 166 annual offerings per year.

Total Estimated Annual Burden: 3,444 hours.

Board

Estimated Number of Respondents: 22 sponsors; 102 annual offerings per year.

Total Estimated Annual Burden: 2,114 hours.

Commission

Estimated Number of Respondents: 181 sponsors; 854 annual offerings per year.

Total Estimated Annual Burden: 17,768 hours.

Commission's explanation of the calculation:

To determine the total paperwork burden for the requirements contained in this rule the agencies first estimated the universe of sponsors that would be required to comply with the disclosure and recordkeeping requirements. The agencies estimate that approximately 270 unique sponsors conduct ABS offerings each year. This estimate was based on the average number of ABS offerings from 2004 through 2013 reported by the ABS database Asset-Backed Alert for all non-CMBS transactions and by Commercial Mortgage Alert for all CMBS transactions. Of the 270 sponsors, the agencies have assigned 8 percent of these sponsors to the Board, 12 percent to the FDIC, 13 percent to the OCC, and 67 percent to the Commission.[380]

Next, the agencies estimated the burden per response that is associated with each disclosure and recordkeeping requirement, and then estimated how frequently the entities would make the required disclosure by estimating the proportionate amount of offerings per year for each agency. In making this determination, the estimate was based on the average number of ABS offerings from 2004 through 2013 and, therefore, the agencies estimate the total number of annual offerings per year to be 1,275.[381] The agencies also made the following additional estimates:

- 12 offerings per year will be subject to disclosure and recordkeeping requirements under § __.11, which are divided equally among the four agencies (*i.e.,* 3 offerings per year per agency);
- 100 offerings per year will be subject to disclosure and recordkeeping requirements under §§ __.13 and __.19(g), which are divided proportionately among the agencies based on the entity percentages described above (*i.e.,* 8 offerings per year subject to §§ __.13 and __.19(g) for the Board; 12 offerings per year subject to §§ __.13 and __.19(g) for the FDIC; 13 offerings per year subject to §§ __.13 and __.19(g) for the OCC; and 67 offerings per year subject to §§ __.13 and __.19(g) for the Commission); and
- 120 offerings per year will be subject to the disclosure requirements under § __.15, which are divided proportionately among the agencies based on the entity percentages described above (*i.e.,* 10 offerings per year subject to § __.15 for the Board, 14 offerings per year subject to § __.15 for the FDIC; 16 offerings per year subject to § __.15 for the OCC, and 80 offerings per year subject to § __.15 for the Commission. Of these 120 offerings per year, 40 offerings per year will be subject to disclosure and recordkeeping requirements under §§ __.16, __.17, and __.18, respectively, which are divided proportionately among the agencies based on the entity percentages described above (*i.e.,* 3 offerings per year subject to each section for the Board, 5 offerings per year subject to each section for the FDIC; 5 offerings per year subject to each section for the OCC, and 27 offerings per year subject to each section for the Commission).

To obtain the estimated number of responses (equal to the number of offerings) for each option in subpart B of the rule, the agencies multiplied the number of offerings estimated to be subject to the base risk retention requirements (*i.e.,* 1,055)[382] by the sponsor percentages described above. The result was the number of base risk retention offerings per year per agency. For the Commission, this was calculated by multiplying 1,055 offerings per year by 67 percent, which equals 707 offerings per year. This number was then divided by the number of base risk retention options under subpart B of the rule (*i.e.,* nine)[383] to arrive at the estimate of the number of offerings per year per agency per base risk retention option. For the Commission, this was calculated by dividing 707 offerings per year by nine options, resulting in 79 offerings per year per base risk retention option.

The total estimated annual burden for each agency was then calculated by multiplying the number of offerings per year per section for such agency by the number of burden hours estimated for the respective section, then adding these

[380] The allocation percentages among the agencies have been adjusted based on the agencies' latest assessment of more recent data, including the securitization activity reported by FDIC-insured depository institutions in the June 30, 2014 Consolidated Reports of Condition.

[381] Based on ABS issuance data from Asset-Backed Alert on the initial terms of offerings, supplemented with information from Commercial Mortgage Alert. This estimate includes registered offerings, offerings made under Securities Act Rule 144A, and traditional private placements. This estimate is for offerings that are not exempted under §§ _.19(a)–(f) and _.20 of the rule.

[382] Estimate of 1,275 offerings per year minus the estimate of the number of offerings qualifying for an exemption under §§ __.13, __.15, and 19(g) (220 total).

[383] For purposes of this calculation, the horizontal, vertical, and combined horizontal and vertical risk retention methods under the standard risk retention option are each counted as a separate option under subpart B of the rule.

subtotals together. For example, under § __.10, the Commission multiplied the estimated number of offerings per year for § __.10 (*i.e.,* 79 offerings per year) by the estimated annual frequency of the response for § __.10 of one response, and then by the disclosure burden hour estimate for § __.10 of 6.0 hours. Thus, the estimated annual burden hours for respondents to which the Commission accounts for the burden hours under § __.10 is 474 hours (79 × 1 × 6.0 hours = 474 hours).

For disclosures made at the time of the securitization transaction,[384] the Commission allocates 25 percent of these hours (1,773 hours) to internal burden for all sponsors. For the remaining 75 percent of these hours, (5,319 hours), the Commission uses an estimate of $400 per hour for external costs for retaining outside professionals totaling $2,127,750. For disclosures made after the time of sale in a securitization transaction,[385] the Commission allocated 75 percent of the total estimated burden hours (1,565 hours) to internal burden for all sponsors. For the remaining 25 percent of these hours (522 hours), the Commission uses an estimate of $400 per hour for external costs for retaining outside professionals totaling $208,650.

FHFA: The rule does not contain any FHFA information collection requirement that requires the approval of OMB under the Paperwork Reduction Act.

HUD: The rule does not contain any HUD information collection requirement that requires the approval of OMB under the Paperwork Reduction Act.

C. Commission Economic Analysis

1. Introduction

Pursuant to Section 15G (Section 15G) of the Securities Exchange Act of 1934 (Exchange Act), as added by Section 941(b) of the Dodd-Frank Act, the agencies are jointly prescribing regulations that (i) require a sponsor to retain not less than 5 percent of the credit risk of any asset that the sponsor, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party, and (ii) prohibit a sponsor from directly or indirectly hedging or otherwise transferring the credit risk that the sponsor is required to retain under Section 15G and the agencies' implementing rules.[386] Section 15G also exempts certain types of securitization transactions from these risk retention requirements and authorizes the agencies to exempt or establish a lower risk retention requirement for other types of securitization transactions.

The Commission is sensitive to the economic impacts, including the costs and benefits, of its rules. The discussion below addresses the economic effects of the final rule, including the likely benefits and costs of the rule as well as their effects on efficiency, competition and capital formation. Some of the economic effects stem from the statutory mandate of Section 15G, whereas others are affected by the discretion the agencies have exercised in implementing this mandate. These two types of impacts may not be entirely separable to the extent that the agencies' discretion is exercised to realize the goals of Section 15G.

Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact on competition that the rules would have, and prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the Exchange Act.[387] Further, Section 3(f) of the Exchange Act requires the Commission,[388] when engaging in rulemaking where it is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.

While we make every reasonable attempt to quantify the economic impact of the rule that we are adopting, we are unable to do so for several components of the new rule due to the lack of available data. We also recognize that several components of the new rule are designed to change existing market practices and as a result, existing data may not provide a basis to fully assess the rule's economic impact. Specifically, the rule's effects will depend on how sponsors, issuers, investors, and other parties to the transactions (*e.g.,* originators, trustees, underwriters, and other parties that facilitate transactions between borrowers, issuers and investors) will adjust on a long-term basis to this new rule and the resulting evolving conditions. The ways in which these parties could adjust, and the associated effects, are complex and interrelated. As a result, we are unable to predict them with specificity nor are we able to quantify them at this time.

2. Broad Economic Considerations

a. Policy Goals of the Risk Retention Requirement

Asset-backed securitizations play an important role in the creation of credit by increasing the amount of capital available for the origination of loans and other receivables[389] through the transfer of those assets—in exchange for new capital—to other market participants. The intended benefits of the securitization process include reduced cost of credit and expanded access to credit for borrowers, ability to match risk profiles of securities to investors' specific demands, and increased secondary market liquidity for loans and other receivables.[390]

Asset-backed securitizations can also generate significant risks to the economy. Indeed, many observers claim that the ''originate-to-distribute'' model underlying securitization for some asset classes contributed to the onset of the financial crisis.[391] The informational asymmetries in securitization markets generated between the borrower and the investors in the asset-backed securities, who are the ultimate providers of credit, give rise to the moral hazard problem of loan originators or securitization sponsors incurring risks in the underwriting or securitization process for which they did not bear the consequence. Loan originators who establish and enforce the underwriting standards are best able to understand the potential consequences of their credit decisions. If loan originators hold the loans they originated, then they are more likely to exercise appropriate care in evaluating the credit quality of the loan, including the borrower's ability to

[384] These are the disclosures required by §§ _.4 (c)(1)(i) and (iii), and (c)(2)(i) (as applicable to horizontal interests, vertical interests, or any combination of horizontal and vertical interests); §§ _.5(k)(1)(i), (iii) and (iv) ; _.6(d); _.7(b)(7)(i) through (viii); _.8(c); _.9(d); 10(e); _.11(a)(2); _.13(b)(4)(iii); _.15(a)(4) and (b)(3); _.16(a)(8)(iii); _.17(a)(10)(iii); _.18(a)(8)(iii); and __.19(g)(2).

[385] These are the disclosures required by §§ _.4 (c)(1)(ii) and (c)(2)(ii) (as applicable to horizontal interests, vertical interests, or any combination of horizontal and vertical interests); §§ _.5(k)(1)(ii); _.6(f)(2)(ii); _.7(c)(2)(B); _.9(d)(1); _.11(b)(2)(B); _13(c)(3); _.16(b)(3); _17(b)(3); _.18(b)(3); and __.19(g)(3).

[386] *See* 15 U.S.C. 78o–11(b), (c)(1)(A) and (c)(1)(B).

[387] 15 U.S.C. 78w(a).

[388] 17 U.S.C. 78c(f).

[389] While most securitized assets are loans or other extensions of credit, other assets are routinely securitized. This discussion focuses on loans because they are the most commonly securitized assets and their impact is more widespread. The Commission believes that the impact on other kinds of receivables should be similar.

[390] *See, e.g.,* Board of Governors of the Federal Reserve System, ''Report to the Congress on Risk Retention'' (October 2010) and Financial Stability Oversight Committee, ''Macroeconomic Effects of Risk Retention Requirements'' (January 2011).

[391] Purnanandam, ''Originate-to-Distribute Model and the Sub-Prime Mortgage Crisis'', 24(6) Rev. Fin. Stud. 1881–1915 (2011).

repay. However, if the originator can sell the loan, the originator has less incentive to screen borrowers carefully. Likewise, sponsors have limited incentives to accurately assess the actual risks of the loans they purchase from originators because the consequences of their decisions are passed on to the investors in the asset-backed securities. Further, because both loan originators and asset-backed securities sponsors are compensated on the basis of volume rather than quality of underwriting, there are economic incentives to originate and securitize as many loans as possible. Consequently, default risk is less important to the market participants originating and securitizing loans.

In addition to this fundamental moral hazard problem, other features of the securitization market contribute to the risks posed by these financing transactions. The ultimate investors in the securitized assets have access to less information about the credit quality and other relevant characteristics of the borrowers than either the originator or sponsor, and may not have effective recourse when the assets do not perform as expected. Moreover, in the early 2000s, demand from securitization sponsors for additional assets to securitize encouraged originators to focus capital towards higher risk assets, including the sub-prime residential mortgage market, which serves the mortgage needs of individuals who are less creditworthy than typical home buyers.[392] The effects of these incentives were compounded by the entry of new market originators and sponsors with varying amounts of experience and capacity to effectively evaluate credit risk.

The moral hazard problem may be especially severe when there are inadequate processes in place to elicit sufficient transparency about the assets or securitization structure to overcome informational differences. In these cases, the securitization process can misalign incentives so that the welfare of some participants is maximized at the expense of other participants. Many of these risks are not adequately disclosed to investors in securitizations, an issue compounded as sponsors introduce increasingly complex structures.[393] The financial crisis also revealed that credit rating agencies had generally not appropriately evaluated the credit risk of certain asset-backed securities. In particular, credit rating agencies assigned high ratings on the senior classes of RMBS or CDOs backed by RMBS that were subsequently not supported by the actual performance of those securities.[394]

Requiring the retention of credit risk by sponsors of asset-backed securities is intended to address these misaligned incentives by requiring originators and sponsors of asset-backed securities to internalize some of the same risks faced by the investors in those asset-backed securities. For example, risk-averse sponsors will be reluctant to absorb the uncertain payouts associated with high-risk loans. In order to limit their exposure to loans with high default risk, these sponsors will be incentivized to scrutinize loan originators' loans and underwriting procedures more carefully.[395] Under the risk retention requirements, securitized loans should therefore be less subject to the lax lending and credit enhancement standards that imposed large losses on asset-backed securities (in particular, RMBS) investors during the financial crisis. By requiring sponsors to retain credit exposure to the securitized assets, risk retention is intended to ensure that sponsors have ''skin in the game'' and thus are economically motivated to be more judicious in their selection of loans being securitized, thereby helping to produce asset-backed securities collateralized by loans with higher underwriting standards. More generally, when a sponsor or originator with better information about the securitized loans is required to hold some of the same risks being transferred to asset-backed securities investors, those investors should be subject to lower risks. When a sponsor shares the risk of the securitized loans with asset-backed securities investors, the sponsor is more likely to be aware of the exact nature and scope of the potential risks, and therefore to be in a position to provide those investors with more accurately represented risks.

b. Potential Economic Effects of Requiring Risk Retention

Mandatory risk retention reflects a belief that sponsors of asset-backed securities have a more accurate assessment of the underlying assets' risk properties than can be attained by their ultimate investors. This information asymmetry can have adverse market effects to the extent that sponsors seek to profit from their differential information. Some observers contend that during the financial crisis, sponsors sold assets that they knew to be very risky, without conveying that information to ABS investors. One way to offset information asymmetries is to require that sponsors retain some ''skin in the game,'' through which loan performance can affect sponsors' profits as much as—or more than—those of the ABS investors.

The standard forms of risk retention in the final rule include a vertical option, a horizontal option, or a combination of a vertical option and a horizontal option. Sponsors' choice of a particular risk retention option will depend on tradeoffs among direct costs, the sponsors' required returns on capital, and investors' uncertainty about the quality of the underlying loan pool. In turn, the overall economic impact of requiring risk retention will depend on the form in which it is held by sponsors.[396] A sponsor relying exclusively on the vertical risk retention option will hold 5 percent of every tranche, from the senior tranche to the residual interest, and shares the same credit risk as investors in every tranche. The retention of a 5 percent vertical slice of ABS securities ties the sponsor's profits to the underlying assets' default rates. For any given securitization of assets characterized by a fixed set of underlying loan interest rates, the ABS

[392] Dell'Ariccia, Deniz and Laeven, ''Credit Booms and Lending Standards: Evidence from the Subprime Mortgage Market'', Journal of Money, Credit and Banking, vol. 44, no. 2–3, pp. 367–384, March-April 2012; Mian and Sufi, ''The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis'', Quarterly Journal of Economics 2009, vol. 124, no. 4, pp. 1449–1496.

[393] Furfine, Complexity and Loan Performance: Evidence from the Securitization of Commercial Mortgages, Review of Corporate Finance Studies, v. 2, no. 2, March 2014, pp. 154–187; Ghent, Torous, and Valkanov, Complexity in Structured Finance: Financial Wizardry or Smoke and Mirrors? (2013, Working Paper, available at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2325835*).

[394] *See, e.g.,* Benmelech and Dlugosz, 2010, The Credit Rating Crisis, Chapter 3 of NBER Macroeconomics Annual 2009, Vol. 24, pp. 161–207, Acemoglu, Rogoff and Woodford, eds., University of Chicago Press; Bolton, Freixas and Shapiro, ''The Credit Ratings Game'', Journal of Finance, vol. 67, no. 1, pp. 85–111, February 2012; Griffin and Tang, ''Did Subjectivity Play a Role in CDO Credit Ratings?'', Journal of Finance, vol. 67, no. 4, pp. 1293–1328, August 2012.

[395] Likewise, if the originator were required to share in the pool's risk, or were required to buy back loans that did not meet pre-specified underwriting standards, the originator could be incentivized to exercise more care in making loans. However, because such arrangements are unfunded, they may not effectively mitigate the moral hazard problem described above, and investors may not benefit from the credit protection because the obligor under the unfunded obligations may not be able to fulfill those obligations when they come due. Consequently, the agencies have not recognized these arrangements as acceptable forms of risk retention.

[396] *See* Section 5.a of this Economic Analysis for further detailed discussion of the economic effects associated with the different options of standard risk retention. Section 5.b discusses additional forms of risk retention available to sponsors of certain securitization structures, including revolving pool securitizations, tender option bonds, and asset-backed commercial paper conduits.

sponsor earns less if the loans default at a higher-than-expected rate. This gives the sponsor an enhanced incentive to be sure that the loan interest rates accurately reflect the loans' expected default rates. ABS investors can therefore be more confident that their ABS interests will perform as promised when the ABS sponsor retains a vertical slide of risk. In other words, the information asymmetry between sponsor and investors is ameliorated by the risk retention requirement, which leads the sponsor to make sure that loan interest rates reflect their expected default probabilities.[397]

An eligible horizontal residual interest, or EHRI, is the most subordinated tranche(s) of a securitization, which exposes the owner to a *disproportionate* share of losses from the securitized loans.[398] A sponsor holding an EHRI will suffer greater default losses from a given percentage investment than from an equal percent investment in a vertical slice, making it a more expensive form of risk retention. Horizontal risk retention is nonetheless the norm in some market segments because ABS investors' beliefs about the quality of loans in the securitization are influenced by the ABS sponsor's exposure to credit losses. Investors can therefore be more confident that the underlying assets are high-quality when the sponsor retains a larger subordinate exposure.[399] In other words, the sponsor ''signals'' to ABS investors its belief that defaults will be low by taking a larger, but junior, claim on the portfolio's cash flows.

In general, although ABS investors may find it difficult to assess the securitized assets' risks on their own, sponsors can signal the quality of the underlying assets by purchasing a first loss position at a price that reflects its fundamental value only if loan defaults turn out to be low. Relatively larger residual interest tranches may be required when the assets being securitized suffer from more acute information asymmetries or higher uncertainty about their true default risk. Horizontal risk retention forces the sponsor to accept more default losses than an equal investment in vertical retention. But the increased risk exposure permits a horizontal risk position to signal the pool's asset quality and, in turn, permits the securitization transaction to provide an economically efficient source of funding for the sponsor.

We anticipate that the ultimate market impact of the credit risk retention requirements will depend in part on the individual sponsor's level of risk aversion and required return on invested capital. Some sponsors may find that holding relatively more risky assets would adversely impact their financial position. The risk retention requirement will incentivize these sponsors to securitize assets with lower default risk. Securitizing assets with lower anticipated losses would lessen the resulting credit risk exposure for asset-backed securities investors. Higher-quality loan pools with more homogenous risk characteristics would give sponsors more incentive to provide accurate information about the pool's risk characteristics. With less uncertainty about the quality of securitized assets, investors should be willing to pay more or demand a lower rate of return for bearing the credit risk, which in turn could reduce borrowing costs for underlying borrowers. Thus, the net effect of reducing the moral hazard in a securitization transaction may be to reduce the cost of loans for more creditworthy borrowers.

The risk retention requirements, however, will not necessarily increase the quality of all loan pools offered for securitization. Asset-backed securities investors may fund riskier pools provided that they are properly compensated (in the form of higher promised tranche returns). The market's appetite for risk could lead sponsors to package high-risk loans that can generate high expected returns. Sponsors with higher cost of capital may also need to earn higher return on their retained tranches, which requires that the underlying loans have higher interest rates, which tend to be riskier loans. Less creditworthy borrowers could be required to pay higher loan interest rates than in the past to the extent that the risk retention requires sponsors to more accurately account for the potential losses associated with these riskier loans.

The effect of risk retention on borrowing costs will also depend on how securitization investors react to the requirements of the final rule. If risk retention increases investor confidence that incentives are properly aligned in the securitization market, this should increase their likelihood of participating in the market, making more capital available and increasing competition for issuances of asset-backed securities. As a result, the higher prices paid for issuances will mitigate the costs imposed on sponsors to retain credit risk. In the past, asset-backed security investors did not always have accurate, timely or accessible information about securitized asset quality and in certain instances were misled about the quality of those assets.[400] If risk retention results in the transmission of more accurate information about loan quality to investors (*e.g.,* through pricing of EHRIs, the level of horizontal risk retention, or fair value disclosures) and allows asset-backed security investors to distinguish lower quality loans from higher quality loans, then risk should be more efficiently priced in asset-backed security markets.

Quantifying the potential impact of the credit risk retention on borrowing rates of the loans underlying the asset-backed securities will depend on the tradeoff between the costs associated with financing the additional capital required by sponsors to fund the retained risk and its effect on the pricing of the asset-backed securities. For example, two studies by the Federal Reserve Bank of New York estimate the potential impact of risk retention on the cost of residential mortgage borrowing by estimating the change in interest rates on securitized loans required to compensate for the sponsors' risk retention requirements.[401] The analyses suggest that incremental increases to sponsors' rate of return requirements for securitizations of residential mortgage loans with higher levels of risk retention are relatively modest, approximately 0–30 basis points.[402] These estimates

[397] If sponsors are risk-averse, vertical risk retention might also discourage them from securitizing higher-risk loans. See below.

[398] Sponsors also share credit risk in a horizontal manner through overcollateralization, subordinated management fees, or other arrangements. Many of such arrangements are unfunded, however, and consequently, the agencies have not recognized them as acceptable forms of risk retention.

[399] Two papers provide evidence that risk retention by a lead underwriter affects the risks perceived by other, less informed, members of the syndicate. Victoria Ivashina, 2009, Asymmetric information effects on loan spreads, Journal of Financial Economics, vol. 92, no. 2, pp. 300–319; Amir Sufi, 2007, Information Asymmetry and Financing Arrangements: Evidence from Syndicated Loans, The Journal of Finance, vol. 62, no. 2, pp. 629–668.

[400] *See* Piskorski, Seru, and Witkin, 2013, Asset Quality Misrepresentation by Financial Intermediaries: Evidence from RMBS Market, NBER Working Paper No. 18843; and Griffin and Maturana, Who Facilitated Misreporting in Securitized Loans? Journal of Finance, forthcoming. Both papers find evidence of mortgage misreporting in non-agency RMBS by both originators and underwriters; this misreporting was not priced by investors at issuance and yet strongly predicted future RMBS losses.

[401] *See* appendix A of the 2013 Reproposal, 78 FR at 58019.

[402] This assessment assumes that the underlying loan pool characteristics are accurately disclosed and with sufficient detail for investors to properly assess the underlying risk. Such a scenario would be reflective of the risk retention requirements solving the moral hazard problem that might otherwise result in the obfuscation of intrinsic risks to the ultimate investors. These results also rely on

Continued

suggest that the underlying loans would need to have an interest rate approximately 0.25 percent higher. As discussed above, however, risk retention will likely influence the composition of loan pools. Although the New York Fed studies do not incorporate this effect, perceptibly higher quality loan pools will require less costly financing or lower yielding asset-backed securities. Thus, the underlying loan interests rates may rise (due to more risk being borne by the sponsor or high opportunity cost of capital for retained capital) or fall (because the pool is higher quality). By contrast, to the extent that riskier loans continue to be securitized even with the requirement to retain risk, the underlying loan interest rates are likely to rise. Developments that make riskier loans more expensive, at a cost commensurate to their intrinsic risk, will improve the efficiency of capital markets.

Requiring sponsors to retain risk in the portfolios of assets they securitize could impose significant costs on financial markets. Currently, sponsors who do not retain 5 percent of the securitization deploy those funds to other uses, such as repaying lines of credit used to fund securitized loans, holding other assets or making new loans, which may earn a different interest rate and have a different risk exposure. Tying up capital as a result of the imposition of risk retention requirements could pose an opportunity cost to sponsors who do not currently retain risk and could limit the volume of securitizations that they can sponsor. These costs would likely be passed on to borrowers, either in terms of increased borrowing costs or loss of access to credit. In particular, borrowers whose loans do not qualify for an exemption from risk retention (*e.g.,* those loans that do not meet the underwriting criteria for being deemed a qualified asset) could face increased borrowing costs, or be priced out of the loan market, thus restricting their access to credit. As a result, there could be a negative impact on capital formation by loan originators to the extent that it impedes the flow of capital from ABS investors, particularly if credit is denied to creditworthy borrowers. More generally, if the costs are deemed by sponsors to be significant enough that they would no longer be able to earn a sufficiently high expected return by sponsoring securitizations, this form of supplying capital to lenders would decline.

The net impact of requiring credit risk retention on capital markets and the costs of credit will ultimately depend on the availability of alternative arrangements for transferring capital to lenders and the costs of transferring capital to sponsors. For example, the impact of the potential decrease in the use of securitizations in the residential mortgage market would depend on the cost and availability to lenders of alternative mortgage funding sources, and the willingness of these sponsors to retain the full burden of the risks associated with credit risk retention and securitization. To the extent there are funding alternatives, and these funding alternatives can provide funding to lenders on terms similar to those available as a result of sponsors' use of the securitization markets, the impact of the substitution of these alternatives for securitizations would likely be minimal. Similarly, to the extent that sponsors can find sources of capital at costs similar to the returns paid on retained interests in securitizations, the impact of risk retention requirements would likely be minimal. Currently, there is no relevant and available empirical evidence to reliably estimate the cost and consequence of either such outcome.

c. The Impact of Asset-Level Disclosure and Other Requirements of Revised Regulation AB

On August 27, 2014, the Commission adopted significant revisions to Regulation AB and other rules governing the offering process, disclosure, and reporting for asset-backed securities.[403] Among other things, these revisions require that prospectuses for registered offerings of asset-backed securities backed by residential and commercial mortgages, auto loans and leases, or debt securities (including resecuritizations), and ongoing reports with respect to such securities contain specified asset-level information about each of the assets in the pool.

Increased transparency for these securitizations through the introduction of enhanced disclosure requirements and enhanced transactional safeguards for ABS shelf offerings should help to address the moral hazard problem that contributed to the poor performance of asset-backed securities during the financial crisis.[404] For registered offerings of asset-backed securities subject to the new requirements, the revisions to Regulation AB should improve the amount of information available to investors about the quality of securitized assets. The availability of detailed loan-level data in a machine readable format will provide investors with information needed to perform their own assessments of the associated risks and lessen the risk of overreliance on third-party evaluations such as credit ratings.

The new requirements for shelf offerings of asset-backed securities include additional safeguards to improve the offering process, encourage greater oversight of the structuring and disclosure of the transaction and provide additional recourse for resolving potential problems by providing stronger mechanisms to enforce compliance with the sponsors' representations and warranties.[405] Combined, these rules should improve investors' willingness to invest in asset-backed securities and to help the recovery in the asset-backed securities market with attendant positive effects on informational and allocative efficiency, competition, and the level of capital formation.

The amendments to Regulation AB should significantly reduce the moral hazard problem in the publicly offered asset-backed securities market and offer an important complement to, but not a substitute for, the risk retention requirement. In particular, there are several ways in which the risk retention requirement will further address the moral hazard problem. As an initial matter, the scope of the risk retention requirement is significantly broader than the asset-level disclosure requirements of the revised Regulation AB, which does not apply across all

specific assumptions about the return on equity demanded by different types of sponsors.

[403] Asset-Backed Securities Disclosure and Registration; Final Rule, 79 FR 57184 (Sept. 24, 2014).

[404] *See,* Adam B. Ashcraft & Til Schuermann, *Understanding the Securitization of Subprime Mortgage Credit* (Staff Report, Fed. Reserve Bank of N.Y., Working Paper No. 318, 2008) (identifying at least seven different frictions in the residential mortgage securitization chain that can cause agency and adverse selection problems in a securitization transaction and explaining that given that there are many different parties in a securitization, each with differing economic interests and incentives, the overarching friction that creates all other problems at every step in the securitization process is asymmetric information).

[405] For example, the rules require a minimum three-business day waiting period before the first sale of securities in the offering to provide investors with time to conduct analysis of the offering. Additionally, as a shelf eligibility requirement, the chief executive officer of the depositor must provide a certification at the time of each takedown about the disclosure contained in the prospectus and the structure of the securitization. As another shelf eligibility requirement, the underlying transaction agreements must include provisions that require a review of pool assets upon the occurrence of a two-prong trigger based first upon the occurrence of a specified percentage of delinquencies in the pool and, if the delinquency trigger is met, upon the direction of investors by vote.

asset classes or to unregistered offerings (*e.g.,* private sales of securities to qualified institutional buyers pursuant to Rule 144A under the Securities Act).[406] Hence, the impact of the asset-level disclosure requirements under the revised Regulation AB may be limited by the extent to which market practices for asset classes not covered by the revised Regulation AB and privately offered asset-backed securities do not incorporate or develop similar disclosure standards and sponsors pursue private offerings instead of registered offerings.[407]

There is reason to believe, however, that the revised Regulation AB could have positive spillover effects into the private markets. With the adoption of standardized loan-level disclosures and increased investor confidence in the registered market, similar practices may develop in the private offering market, particularly to the extent that sponsors and investors participate in both markets. At present, 37 percent of the dollar volume of ABS transactions had sponsors who issued both registered and unregistered offerings.[408] With respect to asset classes and originators for which these sponsors have conducted registered offerings, the sponsors would have relatively low incremental costs to apply existing infrastructure developed to comply with the new disclosure requirements of Regulation AB in any private market offerings that they may conduct for those asset classes and those originators.

These benefits will be further supplemented with the overlay of the risk retention requirements. Risk retention forces sponsors to internalize the costs of inappropriate behaviors such as the obfuscation of the intrinsic risks of the securitization and failure to do appropriate diligence. This internalization will occur contemporaneously with the losses incurred by investors. In contrast, even with the additional disclosures and transactional safeguards required under the revised Regulation AB, sponsors may misrepresent the characteristics of the securitized assets and, in such cases, investor recourse to the sponsor can only occur after the fact of the losses, such as through legal remedy. Analysis from recent studies and details of Commission enforcement cases show that RMBS sponsors misrepresented the quality of the securitized asset pool in RMBS prospectuses leading up to the financial crisis.[409] The additional disclosure requirements and transactional safeguards mandated by Regulation AB may not cause sponsors of registered securitizations to internalize the costs of such practices as fully as if the sponsor retained a portion of the credit risk. Thus, the risk retention requirements for certain registered offerings should be beneficial even with the existence of Regulation AB's additional disclosure and transactional requirements because those disclosure requirements do not create the same alignment of interests of sponsors and investors that would serve to reduce the prevalence of moral hazard and improve underwriting in the publicly offered securitization market.

The disclosure practices that evolve in connection with revised Regulation AB will work together with the credit risk retention requirement to address the moral hazard problem in the publicly offered asset-backed securities market, encourage better underwriting, and better inform investors on the nature of the retained risk. In particular, revised Regulation AB may influence a sponsor's choice between the vertical and (potentially more costly) horizontal forms of risk retention. The revisions to Regulation AB require public disclosure of asset-level information for registered offerings, and because investors in these transactions will be able to better assess the characteristics of the securitized assets, they may be willing to invest in more risky tranches of securitizations, which could increase the ability of the sponsor to rely on a larger vertical interest. As a result, more sponsors might choose to use the less costly vertical risk retention option (or, if they use a combination of the horizontal and vertical forms of risk retention, they might choose to reduce the relative weight of the horizontal form and increase the relative weight of the vertical form), and if so, the implementation of the revisions to Regulation AB could reduce the costs of risk retention to sponsors of registered offerings.

After the implementation of both revised Regulation AB and the risk retention rules, asset-backed securities offerings will be subject to varying levels of compliance with asset-level requirements and the risk retention rules, which may result in differing levels of incentive alignment and transparency. Offerings would fall into different groups[410] and these groups may have different levels of exposure to underwriting quality, moral hazard and asymmetric information problems and may attract different types of investors because different risk tolerances among investors will result in preferences for different types of asset classes and offering methods. Some of these offering groups would be subject to higher underwriting standards and lower risk of default, but could be relatively more exposed to the moral hazard problem (*e.g.*, an incentive to misrepresent the characteristics of the securitized assets) due to the lack of risk retention and asset-level disclosures. Other offering groups may contain lower quality assets, but could be less exposed to the moral hazard problem because of the risk retention requirement. Such distinction could create different demand for each group commensurate with the level of perceived asset underwriting quality and moral hazard, with corresponding implications for risk premium and cost of capital.

3. Economic Baseline

The baseline the Commission uses to analyze the economic effects of the risk retention requirements mandated by

[406] Using the Asset-Backed Alert and Commercial Mortgage Alert databases, DERA staff calculated that, during the 2009–2013 period, only 12.8 percent of non-U.S. agency asset-backed securities deals (excluding ABCP and TOB), or 24.5 percent by dollar volume, will be subject to asset-level disclosure requirements under revised Regulation AB.

[407] The Commission continues to consider whether asset-level disclosure would be useful to investors across other asset classes as well as in private offerings. See revised Regulation AB Adopting Release, 79 FR at 57191 and 57197.

[408] AB Alert.

[409] For example, in 2013, the Commission charged Bank of America entities for failing to disclose key risks and misrepresenting facts about the mortgages underlying an RMBS securitization that the firms underwrote, sponsored, and issued in 2008 (see Commission press release of August 6, 2013, available at *http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539751924*). Similarly, in 2014, the Commission charged Morgan Stanley entities, with misleading investors and misrepresenting the current or historical delinquency status of mortgage loans underlying two subprime RMBS securitizations that the firms underwrote, sponsored, and issued in 2007 (see Commission press release of July 24, 2014, available at *http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542355594*). See also footnote 400 for academic papers that find evidence of mortgage misreporting in non-agency MBS by both originators and underwriters.

[410] The groups are: (1) Those where the sponsor is subject to risk retention and for which asset-level disclosure is required (*e.g.*, registered RMBS of loans that are not qualified residential mortgages (QRM), CMBS of loans that are not qualifying commercial real estate (QCRE) loans, and registered asset-backed securities backed by non-qualifying automobile loans); (2) those for which only asset-level disclosure is required (*e.g.*, registered RMBS of QRM loans, registered CMBS of QCRE loans, and registered asset-backed securities backed by qualifying automobile loans); (3) those for which only risk retention is required (*e.g.*, unregistered RMBS of non-QRM loans, unregistered CMBS of non-QCRE loans, unregistered asset-backed securities backed by non-qualifying automobile loans, and all unregistered asset-backed securities backed by any other assets not otherwise exempt from risk retention); and (4) those for which neither asset-level disclosure nor risk retention is required (*e.g.*, unregistered non-U.S. agency RMBS backed by QRM loans and U.S. agency RMBS).

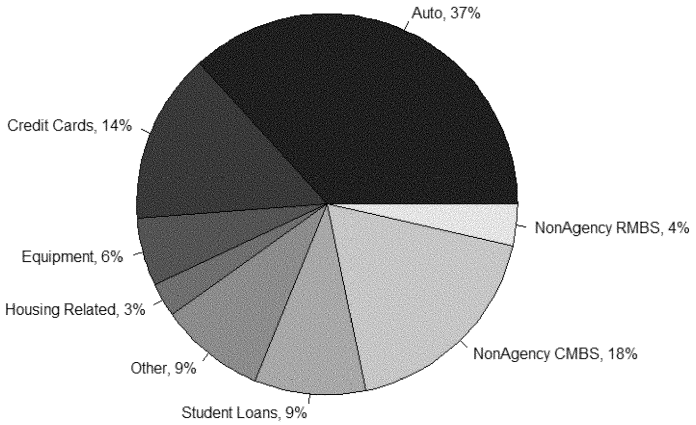
Section 15G is the current set of rules, regulations, and market practices that may affect the amount of credit exposure retained by sponsors. To the extent not already encompassed by current market practices, the risk retention requirements being adopted are expected to have a significant impact on market practices of, and risks faced by, asset-backed securities market participants, including loan originators, sponsors and investors in asset-backed securities, and consumers and businesses that seek access to credit using financial products that are securitized. The costs and benefits of the risk retention requirements depend largely on the current market practices specific to each securitization asset class—including current risk retention practices—and corresponding asset characteristics. The magnitude of the potential effects of the risk retention requirements depend on the overall size of the securitization market and the extent to which the requirements affect borrower access to credit and the cost of capital for lenders. The discussion below describes the Commission's understanding of the securitization markets that are affected by the final rule.[411]

a. Size of Securitization Markets

The asset-backed securities market is important for the U.S. economy and comprises a large fraction of the U.S. debt market. During the five-year period from 2009 to 2013, 31.5 percent of the $33.2 trillion in public and private debt issued in the United States was in the form of mortgage-backed securities (MBS) or other asset-backed securities, and 3.0 percent was in the form of non-U.S. agency backed (private label) MBS or asset-backed securities. For comparison, 32.9 percent of all debt issued was U.S. Treasury debt, and 5.6 percent was municipal debt at the end of 2013.[412] Figure 1 shows the percentage breakdown of total non-agency issuances from 2009 to 2013 for various asset classes excluding short term asset-backed securities, such as asset-backed commercial paper (ABCP) or Tender Option Bonds (TOBs) and excluding collateralized loan and debt obligations (CLOs and CDOs).[413] Consumer credit categories, including asset-backed securities backed by automobile loans and leases and credit card receivables, comprise 37 percent and 14 percent of the total annual issuance volume, respectively. Non-agency RMBS and CMBS comprise 4 percent and 18 percent of the market, respectively, while asset-backed securities backed by student loans account for 9 percent of the market. Below the Commission analyzes the variation in issuance among these five largest asset classes. For several categories, the Commission outlines detailed information about issuance volume and the number of active sponsors (Tables 2 and 3).

FIGURE 1

Non-Agency MBS/ABS issuance in 2009–2013



Source: SIFMA

Prior to the financial crisis of 2008, the number of non-agency RMBS issuances was substantial. For example, new issuances totaled $760.3 billion in 2005 and peaked at $801.7 billion in 2006. Non-agency RMBS issuances fell dramatically in 2008, to $34.5 billion, as did the total number of sponsors, from a high of 80 in 2006 to 27 in 2008. In 2013, there was only $25.2 billion in new non-agency RMBS issuances by 22 separate sponsors.

[411] The impact of the recently adopted but not yet effective revisions to Regulation AB is discussed in Section 2.c of this Economic Analysis.

[412] Source: SIFMA Statistics available at *http://www.sifma.org/research/statistics.aspx*, accessed on July 11, 2014.

[413] To estimate the size and composition of the private-label securitization market, the Commission uses data from the Securities Industry and Financial Markets Association (SIFMA) and Asset-Backed Alert. It is not clear how corporate debt repackagings are classified in these databases. In the following analysis, the Commission excludes all securities guaranteed by U.S. government agencies. ABCP is a short-term financing instrument and is frequently rolled over; thus, its issuance volume is not directly comparable to the issuance volume of other asset classes of asset-backed securities.

TABLE 2—ANNUAL ISSUANCE VOLUME AND NUMBER OF SPONSORS BY OFFERING TYPE FOR ASSET-BACKED SECURITIES BACKED BY CONSUMER LOANS

Year	Credit Card ABS				Automobile ABS				Student Loan ABS			
	SEC	144A	Private	Total	SEC	144A	Private	Total	SEC	144A	Private	Total
Panel A—Annual Issuance Volume by Offering Type ($ bn)												
2005	61.2	1.8	0.0	62.9	85.1	8.7	0.0	93.9	54.1	8.1	0.4	62.6
2006	60.0	12.5	0.0	72.5	68.0	12.2	0.0	80.2	54.9	10.9	0.5	66.2
2007	88.1	6.4	0.0	94.5	55.8	6.8	0.0	62.6	41.7	16.0	0.6	58.3
2008	56.7	5.0	0.0	61.6	31.9	5.7	0.0	37.6	25.8	2.4	0.0	28.2
2009	34.1	12.5	0.0	46.6	33.9	15.4	0.0	49.2	8.3	12.5	0.0	20.8
2010	5.3	2.1	0.0	7.5	37.9	15.3	0.0	53.2	2.8	16.2	1.2	20.2
2011	10.0	4.8	1.5	16.3	41.9	14.4	0.0	56.3	2.5	13.9	1.1	17.5
2012	28.7	10.5	0.0	39.2	65.6	13.9	0.0	79.5	6.6	23.2	0.0	29.9
2013	32.0	3.1	0.0	35.1	62.5	12.8	0.0	75.2	6.5	14.9	0.0	21.4
Panel B—Annual Number of Sponsors by Offering Type												
2005	13	5	0	17	30	9	0	38	13	7	1	19
2006	10	11	0	18	23	12	0	30	8	17	1	24
2007	12	8	0	16	23	9	0	28	7	17	1	22
2008	9	3	0	11	16	8	0	21	3	6	0	8
2009	9	6	0	11	13	13	0	22	3	6	0	6
2010	5	5	0	9	19	15	0	27	2	18	1	19
2011	5	7	1	12	14	16	0	25	1	19	1	20
2012	7	9	0	13	18	24	0	36	1	26	0	26
2013	9	5	0	14	17	19	0	32	1	22	0	22

Notes: The numbers in the table were calculated by staff from the Commission's Division of Economic and Risk Analysis (DERA) using the Asset-Backed Alert database. The deals are categorized by offering year, underlying asset type, and offering type (SEC registered offerings, Rule 144A offerings, or traditional private placements). Automobile asset-backed securities include asset-backed securities backed by automobile loans and leases, both prime and subprime, motorcycle loans, and truck loans. Panel A shows the total issuance amount in billions of dollars. Panel B shows the number of unique sponsors (based on sponsor name) of ABS in each category (the number in the column "Total" may not be the sum of the numbers in the columns "SEC", "144A" and "Private" because some sponsors may sponsor deals in several categories). Only asset-backed securities classified by Asset-Backed Alert as deals sold in the U.S. and sponsors of such deals are counted.

TABLE 3—ANNUAL ISSUANCE VOLUME AND NUMBER OF SPONSORS BY OFFERING TYPE FOR REAL ESTATE-BACKED ABS

Year	Non-agency RMBS				CMBS			
	SEC	144A	Private	Total	SEC	144A	Private	Total
Panel A—Annual Issuance Volume by Offering Type ($ bn)								
2005	738.5	21.7	0.0	760.3	136.23	34.44	0.00	170.68
2006	727.1	74.6	0.0	801.7	161.76	41.05	0.00	202.81
2007	634.8	80.4	0.0	715.3	190.57	40.58	0.00	231.15
2008	12.2	22.3	0.0	34.5	10.71	1.49	0.00	12.20
2009	0.0	48.1	0.0	48.1	0.00	6.86	0.00	6.86
2010	0.2	67.2	12.8	80.3	0.00	19.54	0.00	19.54
2011	0.7	40.8	9.7	51.3	8.45	26.05	0.00	34.50
2012	1.9	27.0	0.0	29.0	32.56	18.68	0.00	51.24
2013	4.0	21.1	0.0	25.2	53.07	33.27	0.00	86.35
Panel B—Annual Number of Sponsors by Offering Type								
2005	54	21	0	60	41	42	0	61
2006	55	43	0	80	39	40	0	57
2007	53	45	0	78	43	29	0	54
2008	12	22	0	27	19	2	0	21
2009	0	17	0	17	0	13	0	13
2010	1	26	1	28	0	25	0	25
2011	1	16	2	18	16	31	0	31
2012	1	20	0	21	26	33	0	56
2013	1	22	0	22	32	57	0	83

Notes: The numbers in the table were calculated by DERA staff using the Asset-Backed Alert and Commercial Mortgage Alert databases. The deals are categorized by offering year, underlying asset type, and offering type (SEC registered offerings, Rule 144A offerings, or traditional private placement). Non-agency RMBS include residential, Alt-A, and subprime RMBS. Panel A shows the total issuance amount in billions of dollars. Panel B shows the number of unique sponsors (based on sponsor name) of asset-backed securities in each category (the number in the column "Total" may not be the sum of the numbers in the columns "SEC", "144A" and "Private" because some sponsors may sponsor deals in several categories). Only asset-backed securities deals classified by Asset-Backed Alert as sold in the U.S. and sponsors of such deals are counted.

Similar to the market for non-agency RMBS, the market for CMBS also experienced a decline following the financial crisis. There were $231.15 billion in new issuances at the market's peak in 2007. New issuances fell to $12.20 billion in 2008 and to $6.86 billion in 2009. In 2013, there were $86.35 billion in new CMBS issuances.

While the markets for asset-backed securities backed by credit card receivables, automobile loans and leases, and student loans experienced a similar decline in issuances following the financial crisis, the issuance trends in Table 2 indicate that they have rebounded substantially more than the non-agency RMBS and CMBS markets. Asset-backed securities collateralized by automobile loans and leases currently have the largest issuance volume and the largest number of active sponsors of asset-backed securities among all asset classes. There were $75.2 billion in new asset-backed securities issuances collateralized by automobile loans and leases in 2013 from 32 sponsors. This amount of new issuances is approximately twice the amount of new issuances in 2008 ($37.6 billion) in this asset class and is similar to the amount of new issuances in this asset class from 2004 to 2007.

Although the amount of new issuances of asset-backed securities backed by credit card receivables has not fully rebounded from pre-crisis levels, it is currently substantially larger than in recent years. There were $35.6 billion in new issuances of asset-backed securities backed by credit card receivables in 2013, a five-fold increase over the amount of new issuances in 2010 ($7.5 billion). The number of sponsors of such transactions has remained steady over time, totaling 14 in 2013. The amount of new issuances of asset-backed securities backed by student loans has also not fully rebounded from pre-crisis levels.[414] There were $21.3 billion in new issuances of asset-backed securities backed by student loans in 2013, compared to a range from $45.9 billion to $58.3 billion between 2004 and 2007. The number of sponsors of such transactions has returned to pre-crisis levels, totaling 22 in 2013.

In addition to these asset classes, sponsors will have to retain risk for all issuances of asset-backed securities, including equipment loans and leases, corporate debt repackagings, TOBs, ABCP, CDOs and CLOs.

Information describing the amount of issuances and the number of sponsors in the ABCP markets is not readily available. Information on the total amount of issuances outstanding indicates that the ABCP market has decreased since the end of 2006, when the total amount outstanding was $1,081.4 billion, or 55 percent of the entire commercial paper market.[415] As of the end of 2013, there were $254.7 billion of ABCP outstanding, accounting for less than 25 percent of the commercial paper market.

TABLE 4—COMMERCIAL PAPER (CP) OUTSTANDING ($BN)

Year	ABCP	All CP outstanding	ABCP share (%)
2004	688.9	1,401.5	49.2
2005	860.3	1,637.5	52.5
2006	1,081.4	1,974.7	54.8
2007	774.5	1,785.9	43.4
2008	734.0	1,681.5	43.7
2009	487.0	1,170.0	41.6
2010	348.1	971.5	35.8
2011	328.8	959.3	34.3
2012	319.0	1,065.6	29.9
2013	254.7	1,086.2	23.4

NOTES: Source—Federal Reserve.

Like other asset-backed securities markets, the CLO market went through the same cycle of high growth right before the crisis in 2005–2007 followed by steep decline in 2008–2010. However, by 2013 the CLO market had almost recovered to its pre-crisis level (see Table 5), in terms of the number of CLO deals per year, the aggregate dollar volume of issuance, and the number of active sponsors (CLO managers). It should also be noted that, in most of the years in the table below, the median sponsor had only one CLO deal sponsored per year.

TABLE 5—ANNUAL ISSUANCE VOLUME AND NUMBER OF SPONSORS FOR ARBITRAGE CLOS[416]

Year	Deals	Total volume, $ bn	Unique CLO managers
2004	89	30.6	60
2005	124	56.05	79
2006	215	106.74	119
2007	187	95.56	101
2008	44	22.05	26
2009	8	2.84	6
2010	7	2.39	6
2011	30	12.86	26
2012	123	55.99	72

[414] The elimination of the Federal Family Education Loan Program (FFELP), a federally guaranteed student loan program, in March 2010 may be a significant contributor to the decline in the issuance of asset-backed securities backed by student loans as no subsequent loans were permitted to be made under the program after June 2010.

[415] Based on information from the Federal Reserve Bank of St. Louis FRED Economic Data database.

TABLE 5—ANNUAL ISSUANCE VOLUME AND NUMBER OF SPONSORS FOR ARBITRAGE CLOS [416]—Continued

Year	Deals	Total volume, $ bn	Unique CLO managers
2013	179	85.83	97

NOTES: The numbers in the table were calculated by DERA staff using the Asset-Backed Alert database. Only arbitrage CLOs backed by corporate loans and sold in the U.S. and sponsors of such deals are counted. The total issuance amount is in billions of dollars.

b. Current Risk Retention Market Practices

As noted earlier, the potential economic effects of the final risk retention requirements will depend on current market practices. Currently, risk retention is not legally mandated in any sector of the U.S. asset-backed securities market (with the exception of the FDIC safe harbor option discussed below where risk retention is one of the compliance options), although some sponsors of different asset-backed securities classes do remain exposed to credit risk, at least at initial issuance, in response to investors' or rating agencies' demand. The new risk retention requirements will impose a cost on sponsors that will depend on the amount and form of risk currently retained by a sponsor of asset-backed securities and the length of time sponsors remain exposed to such risk. Market practices are different for different sectors (to the extent that they are applied at all) and there is no uniform reporting of the types or amounts of risk exposure. Because of the lack of aggregated quantitative information relating to the current risk exposure practices of sponsors, the Commission does not have full information on the extent to which sponsors remain exposed to risk. Below the Commission describes current risk exposure practices for various asset classes based upon its understanding of these markets and public comment received to date.[417] Almost all asset classes include structural features in which sponsors remain exposed to some amount of credit risk, including RMBS, CMBS, automobile loans and leases, credit card receivables, equipment loans and leases and automobile floorplan loans. We note, however, that even if some sponsors voluntarily retain risk in the form of a combination of several tranches, including residual interest that adds up to 5 percent of the principal amount of the deal, the sponsors typically do not contractually commit in the transaction documents to holding these interests after the initial sale (however, a rating agency might downgrade the entire securitization if the residual is sold). Notable exceptions include: TOBs, CLOs and CMBS where depending on the specific structure and the funding needs of the sponsor, either the sponsor or a third party might purchase a residual or equity interest; and structures in which parties involved in the securitization, other than the sponsors, retain risk, such as ABCP conduits, in which the seller of receivables holds a pro rata or residual interest in the receivables sold to the ABCP conduit.

In 2010, the Federal Deposit Insurance Corporation (FDIC) adopted an amended rule regarding the treatment by the FDIC, as receiver or conservator of an insured depository institution, of financial assets transferred by the institution in connection with a securitization.[418] If the FDIC does not deem a transfer of assets to a securitization vehicle a true sale, the FDIC could repudiate transaction agreements for the securitization, recover financial assets that had been transferred, and thereby compromise the ''legal isolation,'' as determined by relevant accounting standards, of the assets upon which the securitization was predicated.[419] The FDIC's rule imposes several new conditions to qualify for a safe harbor from such repudiation, with risk retention being one of the new conditions. Thus, in the absence of other forms of ''true sale'' protection, banking institutions that would like to avoid the potential future FDIC repudiation of a securitization could retain credit risk. As discussed below in Section 3.b.iii, some banks sponsoring asset-backed securities comply with the FDIC safe harbor rule by retaining risk in the form of a representative sample of the securitized assets—one of the forms of risk retention permitted under the FDIC's rule.

Finally, sponsors that intend to market their asset-backed securities in both the United States and the European Union and that issue securities after January 1, 2014, may need to retain 5 percent credit risk to comply with E.U. risk retention rules that, instead of imposing a direct risk retention obligation on sponsors, regulate the types of securities that certain investors can buy.[420] The Commission does not have data on the fraction or types of asset-backed securities currently sold in the U.S. that retain credit risk to comply with these rules or asset-backed securities sold by U.S. sponsors to investors covered by E.U. risk retention rules.

i. Residential Mortgage-Backed Securities

The Commission understands that sponsors of non-agency RMBS historically did not generally retain a portion of credit risk in the form and at a level consistent with the rule being adopted. One study [421] finds that, on

[416] The agencies are adopting a risk retention option for CLOs that meet certain criteria, described herein as ''open-market CLOs.'' Arbitrage CLOs have many of the features of open-market CLOs, but as these requirements were not part of the market prior to this rulemaking, there is no reasonable means of determining which CLOs would have qualified as an open-market CLO.

[417] See also the Board of Governors of the Federal Reserve System's ''Report to the Congress on Risk Retention'' (October 2010), pp. 41–48, where other mechanisms intended to align incentives and mitigate risk are described, including alternatives such as overcollateralization, subordination, guarantees, representations and warranties, and conditional cash flows as well as the retention of credit risk. The report also contains a description of the most common incentive alignment and credit enhancement mechanisms used in the various securitization asset classes. The report does not establish the extent to which these alternatives might be substitutes for the retention of credit risk.

[418] *See* 12 CFR 360.6. Upon their effective date, the final rule will replace the FDIC regulations and shall exclusively govern the requirement to retain credit risk for insured depository institutions.

[419] The FDIC would have to pay damages to the securitization vehicle for any repossessed assets; however, those damages might be less than the full amount of principal and interest due on outstanding securities backed by such assets.

[420] Article 122a of the Capital Requirements Directive mandates that European Economic Area-regulated credit institutions and investment firms and their affiliates may only invest in securitization transactions if the original lender, originator or sponsor of the securitization retains 5 percent of the net economic interest of the transaction. Related EU Alternative Investment Fund Manager's Directive imposes similar risk retention requirements on securitizations that most private equity, real estate investment services and hedge funds are allowed to invest in.

[421] Taylor Begley and Amiyatosh Purnanandam, Design of Financial Securities: Empirical Evidence from Private-label RMBS Deals (2014), University of Michigan working paper. They find that the size of the residual interest is proportional to the fraction of no document loans—their proxy for increased information asymmetry between sponsors and investors.

average, RMBS deals had a 1.2 percent residual interest by face value that was proportional to the perceived level of information asymmetry between the sponsor and ABS investors, although the study could not determine whether sponsors retained the residual interest or, if retained, for how long it was held after issuance. Thus, even if sponsors of RMBS deals were holding the residual interest and were not selling it to third parties, they were not, on average, retaining 5 percent of the credit risk by face value.[422] Consequently, as discussed below, except in the case where exemptions are applicable (*e.g.,* the QRM exemption), the final risk retention requirements likely will impose new constraints on RMBS sponsors.

ii. Commercial Mortgage-Backed Securities

The current risk retention practice in the CMBS market is to retain at issuance the ''first loss piece'' (riskiest tranche). This tranche is typically sold to a specialized category of CMBS investor, known as a ''B-piece buyer.'' [423] The B-piece investors in CMBS securitizations often hold dual roles as bond investors, if the assets remain current on their obligations, and as holders of controlling interests to appoint special servicers, if the loans default and go into special servicing. As holders of the controlling interest, they will typically appoint an affiliate as the special servicer. The B-piece CMBS investors are typically commercial real estate specialists who use their knowledge about the securitized assets in the pools to conduct extensive due diligence on new deals.[424] The B-piece market has very few participants.[425] The B-pieces are often ''buy-and-hold'' investments, and, based on the Commission's knowledge of the asset-backed securities market, the secondary market for B-pieces is relatively illiquid at this time. According to one comment letter, a typical B-piece makes up 2.6 percent of economic and 7 percent of the notional balance of a CMBS. Thus, the Commission believes the prevailing market practice for risk retention in the CMBS sector is to hold less than the final rule's risk retention option for CMBS sponsors.

iii. Master Trusts (Revolving Pool Securitizations)

Master trusts generally issue multiple series of asset-backed securities over time, backed by a common pool of securitized assets. The transaction agreements require the sponsor to maintain the principal balance of the securitized assets at an amount that is at all times sufficient to back the aggregate amount of asset-backed securities outstanding to investors with a specified amount of collateral above that amount. The principal amount of outstanding investor ABS interests changes over time as new series are issued or existing series are paid off. Moreover, as each series is issued, it begins with a revolving period (typically for some number of years), during which the investors receive only interest, and cash from borrower principal repayments on the pool assets are used to buy additional assets for the pool from the sponsor. This provides the sponsor with ongoing funding for its operations, and maintains the level of pool assets over time. Then, at a date specified under the terms of the series, the revolving phase for the series comes to an end, and cash from borrower principal repayments on pool assets is used to repay investors and retire that series of investor ABS interests.

Sponsors of revolving master trusts often maintain risk exposures through the use of a seller's interest which is intended to be equivalent to the sponsor's interest in the receivables underlying the asset-backed securities. In current market practices, the amount and form of risk exposure generally depends on the asset class in the master trust; there is typically more risk exposure for assets with higher rates of default or that are more difficult to assess. For example, credit card master trusts sponsors retain economic exposure through excess spread and fees, while dealer floorplan asset-backed securities have significant residual exposure. The Commission requested additional information about current practices and data from market participants, but none was provided. As a result, the Commission does not have reasonably accessible data about revolving master trusts that would permit it to estimate current market practice about the amount of risk exposure held by sponsors.

As discussed above, banks sponsoring asset-backed securities that intend to comply with the FDIC safe harbor rule could retain 5 percent of credit risk of the securitized pool. Some banks that use trust structures to sponsor asset-backed securities backed by automobile loans and leases use one of the allowed options under the FDIC rule, the representative sample option, to comply with the safe harbor rule requirements. Under this option, the sponsor randomly selects a separate pool of receivables that represents the characteristics of the securitized pool of assets and holds it on their balance sheet.[426]

iv. Other Asset-Backed Securities

The current market practices for other categories of asset-backed securities that serve to align the interests of the sponsor and investors vary across asset classes. The Commission understands that sponsors of automobile loans typically maintain exposure to the quality of their underwriting by retaining a significant residual interest in their securitization transactions. However, there is insufficient data available to the Commission to estimate the fair value of these retained residual interests. Also, as discussed above, some banking institutions that are affiliated with a sponsor of asset-backed securities collateralized by automobile loans and leases retain a 5 percent representative sample to comply with the FDIC safe harbor rule. As noted above, the final rule does not include a representative sample option. The Commission also understands that many sponsors of asset-backed securities backed by student loans did not retain credit risk as many were federally guaranteed. Sallie Mae, the largest sponsor of student loan asset-backed securities, typically retains through an affiliate a residual interest in the form of overcollateralization in the securitizations that it sponsors.

v. Asset-Backed Commercial Paper

ABCP is a type of asset-backed security that is typically issued to investors by a special purpose vehicle (commonly referred to as a ''conduit'')

[422] We also note that one of the largest sponsors of registered RMBS has stated it currently retains some interest in the RMBS transactions that it sponsors. See Sequoia Mortgage Trust 2013–1, Final Prospectus filed pursuant to Rule 424(b)(5), File No. 333–179292–06 filed January 16, 2013; *http://www.sec.gov/Archives/edgar/data/1176320/000114420413002646/v332142_424b5.htm.*

[423] However, not every CMBS deal has a B-piece buyer. According to Commercial Mortgage Alert, 46 percent of CMBS deals in 2009–2013 had a B-piece buyer.

[424] CMBS have much smaller number of underlying loans in a pool (based on data from Commercial Mortgage Alert, in 2009–2013, CMBS, on average, had about 100 commercial properties in a pool, whereas RMBS had about 3,000 assets in a pool and automobile loan/lease ABS typically had 75,000 assets) and these loans are often not standardized. Thus, direct management of individual underperforming loans is often necessary and is much more viable for CMBS than for other asset classes.

[425] Based on Commercial Mortgage Alert data, in 2009–2013, there were 38 different B-piece buyers with 9 of them participating in 70 percent of CMBS deals.

[426] See, for example, Bank of America Auto Trust 2012–1 (*http://www.sec.gov/Archives/edgar/data/1488082/000119312512149853/d309744d424b3.htm*) or Ally Auto Receivables Trust 2012–3 (*http://www.sec.gov/Archives/edgar/data/1477336/000119312512243201/d357186d424b5.htm*).

sponsored by a financial institution. The commercial paper issued by the conduit is collateralized by a pool of asset-backed securities, which may change over the life of the entity. ABCP conduits generally purchase longer-term assets financed by the issuance of shorter-term liabilities, and the liabilities are ''rolled,'' or refinanced, at regular intervals.[427]

In a typical ABCP conduit transaction, the sponsor's customer (an ''originator-seller'') sells loans or receivables to an intermediate, bankruptcy remote special purpose vehicle (SPV). The credit risk of the receivables transferred to the intermediate SPV then typically is separated into two classes—a senior ABS interest that is acquired by the ABCP conduit and a residual interest that absorbs first losses on the receivables and that is retained by the originator-seller. The residual interest retained by the originator-seller typically is sized with the intention that it be sufficiently large to absorb all losses on the underlying receivables.

In this structure, the ABCP conduit issues short-term ABCP that is collateralized by the senior ABS interests purchased from one or more intermediate SPVs, which are, in turn, supported by the subordination provided by the residual ABS interests retained by the originator-sellers (*i.e.,* the sponsors of underlying ABS interests would be subject to risk retention requirements). The sponsor of this type of ABCP conduit, which is usually a bank or other regulated financial institution or their affiliate, also typically provides (or arranges for another regulated financial institution or group of financial institution to provide) 100 percent liquidity coverage on the ABCP issued by the conduit. This liquidity coverage typically requires the support provider to provide funding to, or purchase assets or ABCP from, the ABCP conduit in the event that the conduit lacks the funds necessary to repay maturing ABCP issued by the conduit.

Commenting on the original proposal, ABCP conduit sponsors noted that there are structural features in ABCP securitizations that align the interests of the ABCP conduit sponsor and the ABCP investors. For instance, commenters stated that ABCP conduits usually have some mix of credit support and liquidity support equal to 100 percent of the ABCP outstanding. In the view of commenters, this liquidity and credit support exposes the ABCP conduit sponsor to the quality of the assets in an amount that far exceeds 5 percent of the fair value of the outstanding ABCP.[428]

vi. Collateralized Loan Obligations

A collateralized loan obligation (CLO) is an asset-backed security that is typically collateralized by portions of tranches of senior, secured commercial loans or similar obligations of non-investment grade borrowers.[429] CLOs are organized and initiated by a CLO manager, usually when the CLO manager partners with a structuring bank that assists in financing asset purchases that occur before the formation of the CLO.[430] The CLO manager actively manages the asset portfolio and earns management fees and performance fees for investment management services provided to the CLO.

The Commission understands that CLO managers often retain a small portion—significantly less than 5 percent—of the residual interest, although the party retaining the risk may vary depending on the CLO. Some types of CLO managers are more likely to hold a significant residual interest in their CLO, while others are more likely to secure a third-party equity investor to purchase the residual interest. According to one commenter, a common CLO market practice is for the CLO manager to hold 5 percent of the residual interest, which is typically around 8 percent of the value of the CLO at issuance.[431] This level of retention equates to approximately 0.4 percent of the value of the CLO.

The Commission understands that many CLO structures use overcollateralization—the amount by which the face value of the underlying loan portfolio[432] exceeds the face value of the outstanding asset-backed securities—which many CLO managers consider as a form of risk retention because the value of the overcollateralization is ascribed to the residual interest. For example, the current senior overcollateralization for older vintage CLO 1.0 deals (CLO structure used before the crisis) is 132 percent, while for CLO 2.0 deals (the structure used for newer CLO) it is 135 percent.[433] This means that a CLO 1.0 deal has $132 supporting every $100 of the most senior tranche outstanding. The amount of overcollateralization for the entire CLO structure would be much lower because it would also include mezzanine and subordinate bonds in addition to the residual interest. The agencies do not consider overcollateralization by face value to be an acceptable form of risk retention because the face values of both the securitized assets and of the ABS interests can materially differ from their relative value and/or cost to the sponsor.[434]

The Commission requested comments on whether any practices in the CLO market reflected risk retention as envisioned by the proposed rule. Many commenters indicated that the proposed rule requirements would change current practices and therefore substantially impact the CLO market. No commenter indicated the presence of, or development towards, risk retention practices that would satisfy the requirements of the proposed rule. Some commenters described the amount of risk retention currently held and how managers of CLOs often retain a small portion of the residual interest and asserted that sponsors retain risk through subordinated management and performance fees that have performance components that depend on the performance of the overall pool or junior tranches.[435]

vii. Tender Option Bonds

There are two typical tender option bonds (TOBs) structures that generally have different amounts of risk retention. One type of TOB is a bank-sponsored TOB where a single bank and its affiliates serve as the sponsor, residual holder and liquidity provider; in this structure, the bank will typically hold nominal equity. Commenters noted that the bank's credit exposure is significantly greater than 5 percent because it is the provider of 100 percent

[427] *See* Original Proposal at § __.9.

[428] *See* footnote 395 for the general agencies position on acceptability of unfunded arrangements as forms of risk retention.

[429] The term ''CLO'' is also used to refer to the special purpose vehicle that issues the asset-backed securities and the overall securitization structure.

[430] *Report to the Congress on Risk Retention,* Board of Governors of the Federal Reserve System, at 22 (Oct. 2010), *available at http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf.*

[431] In general, the size of the equity tranche increases in downturns and decreases in booms. See Updating the CLO Primer, Bank of America/Merrill Lynch, July 2012.

[432] The face value of the underlying loans may be adjusted in accordance with the CLOs transaction documents to reflect concentration limits, delinquencies and/or discounted purchase prices.

[433] Asset-Backed Alert, July 11th, 2014.

[434] As discussed below, the final rule does give sponsors credit for overcollateralization to the extent the fair value of the horizontal form of risk retention takes into consideration the fair value of the overcollateralization.

[435] The agencies have not recognized subordinated management fees as an acceptable form of risk retention in the final rule because, if the CLO underperforms, subordinate management fees may not align the interests of the manager with those of investors. See also footnote 395 for the general agencies position on acceptability of unfunded arrangements as forms of risk retention.

liquidity support. The second type of TOB is one in which the bank that is the liquidity provider does not hold the residual interest; in this case the TOB residual holder will retain a more significant amount of risk. Other features of TOBs include a put feature as part of the bond that allows investors to put the bond back to the sponsor and a 100 percent liquidity support. The Commission requested data on current market levels of risk retention for TOBs but received no data from commenters.

4. Analysis of Risk Retention Requirements

As discussed above, the agencies are adopting the rule requiring sponsors of asset-backed securitizations to retain risk. Each of the asset classes subject to the final rule has its own particular structure and, as a result, the implementation and impact of risk retention will vary across asset classes, although certain attributes of risk retention are common to all asset classes. In this section, the Commission discusses those aspects of the final rule that apply across a broad range of asset classes: The requirement that sponsors hold 5 percent of the credit risk of a securitization; the use of fair value of the securitization to measure the amount of horizontal risk retained by the sponsor; and the length of time that a sponsor will be required to hold its risk exposure.

a. Level and Measurement of Risk Retention

i. Requirement To Hold Five Percent of Risk

Section 15G requires the agencies to jointly prescribe regulations that require a sponsor to retain not less than 5 percent of the credit risk of any asset that the sponsor, through the issuance of ABS, transfers, sells, or conveys to a third party, unless an exemption from the risk retention requirements for the securities or transaction is otherwise available. The agencies reproposed a requirement to hold a minimum 5 percent base risk retention for most ABS transactions that are within the scope of Section 15G, with some exemptions.

Commenters did not comment specifically on the discussion of the 5 percent risk retention requirement in the Commission's Economic Analysis in the 2013 reproposal. One commenter did suggest the minimum amount of risk retention be increased to 20 percent. As discussed in more detail below, increasing the minimum amount of risk retention could increase the cost to sponsors and impede capital formation in the economy by preventing the more efficient reinvestment of the sponsors' capital, while not necessarily providing significant incremental benefit to investors. In addition, several commenters suggested risk retention requirements be determined by reference to asset quality.[436]

The agencies are adopting a 5 percent risk retention requirement as reproposed. The Commission lacks the data—and commenters did not provide quantitative information—to allow for analysis of an optimal level of retained risk, taking into account the goal of aligning the incentives of the sponsors and the investors in asset-backed securities. As discussed above, barring any exemption, the required level of risk retention is set by statute at no less than 5 percent. Below is a discussion of the trade-offs between setting the level of required risk retention too high or too low.

As a general matter, if the required level of risk retention is set too low, it may not adequately align the incentives of investors and sponsors. While we recognize that Congress prescribed a minimum level of risk retention, the Commission is also aware that, as discussed in the Economic Baseline, sponsors of asset-backed securities in many asset classes retained less than 5 percent credit exposure to securitizations in the past. Moral hazard problems persisted at these lower levels. In contrast, asset classes with relatively higher levels of risk retention (*e.g.,* asset-backed securities backed by auto loans and leases) performed relatively better throughout the financial crisis.

A level of risk retention that is set too high, however, could lead to inefficient deployment of capital by unduly restricting a sponsor's ability to structure new deals. If sponsors are limited in their ability to secure the necessary financing to retain the required amount of credit risk in their intended offerings, then this could adversely impact the flow of capital from ABS investors to originators of the assets intended for securitization. Hence, excessive required risk retention levels may lead to less capital available to lenders, potentially increasing borrowing rates as borrowers compete for a more limited supply of credit. In this scenario, the reduction in capital formation would have a negative impact on competition due to the increased cost of securitizing non-qualified assets, disadvantaging their ability to be financed by ABS investors relative to qualified assets and other sources of capital.

ii. Measurement of Risk Retention Using Fair Value

The agencies are adopting a requirement for sponsors to measure risk retention of an ''eligible horizontal residual interest'' (EHRI) using a fair value measurement framework consistent with GAAP. As described in the 2013 reproposal, the agencies believe that measuring risk retention with a fair value measurement framework will align the measurement more closely with the credit risk of a securitization transaction than alternative frameworks. The agencies are not requiring vertical interests to be measured using a fair value measurement framework, as proposed, because they were persuaded by commenters that such measurement is not necessary to ensure that the sponsor has retained 5 percent of the credit risk of the ABS interests issued.

Commenters generally supported basing the measurement of the horizontal risk retention requirement on fair value. Some commenters raised general concerns with the proposed method by which sponsors would be required to measure their risk retention because some sponsors do not currently use fair value calculations. Thus, requiring such sponsors to measure their risk retention with fair value would create significant burden and expense. Commenters also expressed several specific accounting concerns regarding use of fair value to measure risk retention. Specifically, they expressed concern regarding the timing of the pre-sale fair value disclosure requirement. Commenters noted that the most objective and accurate way to calculate the fair value of the residual interest is to base the valuation on observable market prices for the remaining securities; however, because the reproposal required that sponsors

[436] The agencies do not believe that it is necessary or appropriate to attempt to vary the amount of risk retention based on the quality of the assets or other, similar, factors. Doing so would unnecessarily complicate compliance with the rule. Furthermore, as discussed in the following section, the Commission believes that requiring risk retention to be measured by fair value adequately incorporates the quality of the assets. Specifically, it would calibrate the sponsor's economic exposure to the asset pool depending on quality of securitized assets. For example, the Commission notes that if the securitized asset pool consists of low-quality assets, the value of the residual interest would be relatively low and a sponsor would have to hold a larger equity tranche to meet the five percent fair value credit risk exposure requirement. On the other hand, if the securitized asset pool consists of high quality assets, the value of the residual interest would be relatively higher and a sponsor would be able to satisfy the requirement by holding smaller residual interest. Use of face value or overcollateralization to avoid the 5 percent risk retention requirement will not be possible using fair value methodologies acceptable under GAAP as it would account for the expected losses associated with the residual interest.

calculate the fair value of the residual interest in advance of the final pricing of the issued securities, the fair value of the residual interest would have to be calculated using estimates of final pricing levels. Commenters asserted that potential differences between the pre-sale fair value calculated using estimated pricing levels and the post-closing fair value calculated using actual pricing levels would confuse investors.

To provide investors with sufficient information to allow them to evaluate whether the sponsor's estimated calculation of fair value was reasonable, the proposed rule would have required sponsors to disclose the key inputs and assumptions used in measuring fair value and the sponsor's technique(s) used to derive the key inputs and assumptions. Many commenters expressed concerns about the proposed requirement, indicating that the proposal would require sponsors to disclose information that is proprietary, highly confidential and commercially sensitive, which could be used by third parties to the competitive disadvantage of the sponsor. Other commenters suggested significant modifications to the disclosure requirements. For example, several commenters asserted that sponsors should only be required to make disclosures to the Commission and banking agencies, rather than to investors. Significant concern was raised regarding potential liability and litigation that commenters indicated may result when fair value projections, assumptions and calculations disclosed to investors turn out to be incorrect.

A few commenters asserted that for simple structures, sponsors should not be required to make fair value determinations or related disclosures, nor should the cash flow restriction (as described below) apply. Several commenters requested that the final rule should not require sponsors to measure and disclose the fair value of eligible vertical interests, so long as the underlying ABS interests have either a principal or notional balance. The commenters noted that a 5 percent interest in the cash flow of each class would always be equivalent to 5 percent of the fair value of each class. In this regard, the commenters asserted that requiring fair value measurement and disclosures for the vertical option would be unnecessary for ensuring compliance with the rule.

The final rule does not require sponsors holding risk retention in a vertical form to measure and disclose the fair value of their vertical risk retention. With the vertical form of risk retention, requiring sponsors to measure and disclose the fair value would impose additional cost on the sponsor with little, if any, corresponding enhancement of investors' ability to evaluate and understand the amount of credit risk exposure of the sponsor. This is because 5 percent of the fair value of each tranche will be equal to 5 percent of face value of each tranche. Therefore, if investors know that a sponsor is holding 5 percent of each tranche, they will be able to assess the credit exposure of the sponsor regardless of whether it is face value or fair value.

Using a fair value measurement framework acceptable under GAAP, as applicable, to value the EHRI will provide a number of benefits. First, it allows investors and sponsors to objectively measure and understand the amount of credit risk exposure of the sponsor. The use of fair value is intended to prevent sponsors from structuring around risk retention, as may otherwise be the case when using the face value of residual interests or overcollateralization to measure the amount of horizontal risk retention. For example, if a sponsor issues $100 million in asset-backed securities at par and retains a first-loss residual interest with a face value of $5 million, that residual interest could yield a market value below $5 million given the expected losses associated with the securitized assets, in which case the sponsor would be holding less than 5 percent of the deal's value. Use of face value or overcollateralization to avoid the 5 percent risk retention requirement will not be possible using fair value methodologies acceptable under GAAP as it would account for the expected losses associated with the residual interest. Moreover, and as a general matter, most investors and sponsors have experience with fair value methodologies acceptable under GAAP and therefore using it in this context will help to minimize the costs of evaluating the amount of risk retention held by sponsors because it will be consistent with other valuation experiences.

There are also potential costs to investors associated with the use of a fair value measurement framework. Fair value is a measurement framework that, for certain types of instruments, where significant unobservable inputs are used to determine fair value, requires an extensive use of judgment. Because of this extensive use of judgment, an investor may be unable to determine if the sponsor's fair value calculation uses assumptions that are similar to the investor's assumptions. In order to help mitigate this potential cost, the agencies also are requiring, as proposed, that the sponsor disclose specified information about how it calculates fair value. While this requirement should discourage manipulation, sponsors will incur additional costs to prepare the necessary disclosures. In addition, because the final rule specifies that fair value must be determined using a fair value measurement framework consistent with GAAP, sponsors will incur costs to ensure that the reported valuations are compliant with the valuation standard.

With respect to the disclosure required in order to allow investors to evaluate and understand the sponsor's fair value calculation, the reproposal discussed the appropriate level of detail to be provided to investors. One approach would be to provide the same model inputs (*e.g.,* prepayment rate, discount rates) that the sponsors used so that investors could more precisely evaluate the sponsor's fair value calculations. While sponsors already have the model inputs they use to calculate fair value, as commenters noted, there may be costs to the sponsors associated with providing investors with sponsors' proprietary information. For example, sponsors may base their model inputs on proprietary information derived from the historical performance data of their loan pools, information that has commercial value and is often compiled and sold to market participants who purchase the data in order to derive model inputs similar to the ones that sponsors would be required to disclose. Disclosure of the model inputs could thus lower the commercial value of the historical data. Disclosing their inputs could also provide competitors—with similar access to historical performance data—with insight into the sponsor's interpretation or selection of relevant benchmark data. Access to this insight could reveal proprietary valuation methods or, as some commenters suggested, give rise to litigation risk to the extent that there are differences in opinions on how to interpret the data. Taken together, requiring sponsors to disclose precise information about their model inputs could increase the cost to sponsors without necessarily providing additional benefit to investors.

To help mitigate these potential costs, the final rule permits the disclosure of fair value based on estimated ranges for tranche size, interest rates for each tranche, and underwriting discount. The information is required to be provided a reasonable amount of time prior to the sale of the asset-backed security. Also required to be included are the sponsor's key inputs and assumptions that may be described as a curve. The rule requires that this disclosure be

updated to reflect actual fair values of the ABS interests sold at the closing date. This approach may enable investors to make meaningful assessments of whether a sponsor's fair value calculations are reasonable prior to making their investment decisions, and at the same time may help to address sponsors' concerns about disclosing what they believe to be proprietary information and the timing of the disclosure. The ranges of pricing information will allow investors to decide if the sponsor's model input curves are aggressive or conservative compared to their own expectations based on their experiences and knowledge of the asset class.

In the case of revolving pool securitizations, the agencies are permitting the seller's interest option to be measured using face value. These securitizations have unique structures described further below that would address the agencies' concerns about the use of face value of the ABS interests or the face value of the securitized assets to circumvent risk retention requirements as described above. This option recognizes the unique characteristics of certain structures and the impact of those structures on the alignment of incentives for the transaction parties. This option also helps to minimize the burden of fair value disclosure discussed in the reproposal while still allowing certain structures to have a meaningful amount of risk retained and addressing some commenters' concerns about using a fair value measurement framework to measure risk retention. One unique characteristic is that the vehicle will engage in multiple issuances for the life of the master trust. Because of this, if the revolving pool securitization contains poorly underwritten receivables that are expected to default then, in the future, this will impact the ability of the sponsor to make future issuances of asset-backed securities using the revolving pool securitization. The structure of revolving pool securitizations aligns incentives between sponsors and investors, reduces the need for fair value measurement that does not bring benefits to investors, and allows for face value measurement, which will help to minimize costs for sponsors of revolving pool securitizations.

b. Duration of the Risk Retention Requirement

Under the reproposal, sponsors would have been prohibited from selling or otherwise transferring any interest or assets that they would be required to retain under the rule to any person other than a consolidated affiliate for specified time periods. For all ABS other than RMBS, the specified time period would have been the later of two years after the closing date of the securitization or when the aggregate unpaid balance of the ABS interests has been reduced to 33 percent. For RMBS, the specified time period would have been the later of five years after the closing of the securitization or when the pool balance has been reduced to 25 percent, but in no event later than seven years after the closing of the securitization.

In response to the reproposal, commenters recommended various modifications to the length of risk retention requirements. Some commenters suggested lengthening the non-RMBS duration to three years, while other commenters questioned why only RMBS and CMBS had asset specific durations and suggested lengthening or shortening periods of time that were tied to a specific asset class or securitized asset quality. Finally, some commenters suggested eliminating the alternative sunset period contingent on the unpaid pool balance.

The agencies are adopting the sunset provisions as reproposed. The Commission lacks the data to determine an optimal duration of these risk retention requirements, and while commenters supported their positions based on relevant time periods that are tied to securitized assets, no commenters submitted relevant data or other quantifiable information. In particular, as stated in the reproposal, these time periods were chosen to strike a balance between retaining risk long enough to align the sponsors' and investors' incentives and allowing the redeployment of retained capital for other productive uses. A shorter duration was chosen for non-mortgage asset classes, because these loans tend to have shorter maturities than mortgages and thus it may not be necessary to retain risk for a longer period. The alternative sunset component contingent on the reduction of pool balance further calibrates the required duration of risk retention based on the remaining balances. By the time the loan pool balance decreases to 33 percent, the information about the loan pool performance will be largely revealed, at which point the moral hazard problem between the sponsor and the investor is likely to be significantly reduced.

We recognize that, in the case where the loan pool balance drops below the prescribed threshold (25 percent for RMBS and 33 percent for other ABS) before the prescribed number of years (five years for RMBS and two years for other ABS), the additional required duration might be costly to the sponsor. A requirement that the sponsor continue to retain exposure to the securitization once the impact of the initial uncertainty about the ABS is resolved could potentially impede allocative efficiency by limiting the sponsor's ability to redeploy capital to new securitizations or other investment opportunities. Moreover, as loan balances are paid down, the sponsor may hold more risk relative to other investors because the size of the credit risk retention piece is based on the initial size of the securitization and does not change with the current market value. Thus, sponsors could face increased levels of risk retention on a percentage of outstanding basis at the same time retained risk becomes less necessary. While economic efficiency might be increased in certain circumstances by allowing sponsors to withdraw their risk retention investment to use in new securitizations or other credit forming activities,[437] the minimum fixed duration of risk retention is appropriate to prevent structuring securitizations that would be quickly paid off to the balance threshold points (25 percent or 33 percent) for the purposes of avoiding risk retention.

5. Forms of Risk Retention Menu of Options

Rather than prescribe a single form of risk retention, the final rule allows sponsors to choose from a range of options to satisfy their risk retention requirements. As a standard form of risk retention available to sponsors of all securitizations, sponsors may choose vertical risk retention, horizontal risk retention, or any combination of those two forms. Both the vertical and horizontal forms of risk retention require the sponsor to share the risk of the securitized asset pool. The final rule also includes options tailored to specific asset classes and structures such as revolving master trusts, CMBS, ABCP, CLOs, and TOBs. Given the special characteristics of certain asset classes, some of these options permit the sponsor to allocate a portion of the shared risk to originators, allow the risk to be held by specified third parties, or

[437] *See* Hartman-Glaser, Piskorski and Tchistyi, 2012, Optimal Securitization with Moral Hazard. *Journal of Financial Economics,* vol. 104, no. 1, April 2012, pp. 186–202. They consider the optimal design of MBS contracts between a mortgage underwriter that can engage in costly hidden effort to screen borrowers and investors and show, among other things, that the maturity of the optimal contract can be short.

allow the risk to be held in an identical asset outside of the securitization.

Commenters generally supported the menu-based approach of providing sponsors with the flexibility to choose from a number of permissible forms of risk retention. These commenters believed that this provides sponsors with the flexibility to structure their risk retention requirements to accommodate current market practices.

By adopting a rule that will allow sponsors flexibility to choose how they retain risk, the agencies seek to enable sponsors to select the approach that is most cost-effective for them, while still fulfilling the purposes of Section 15G. As discussed previously, the agencies are sensitive to the need to balance the goals of risk retention (reduction of the moral hazard problem and better underwriting) with the need to facilitate the efficient deployment of capital. A flexible approach to retaining risk will permit sponsors to take into account a variety of factors, as discussed in more detail below.

Various factors are likely to impact sponsors' preferred method of retaining risk, including size, funding costs, financial condition, riskiness of the securitized assets, potential regulatory capital requirements, return on capital requirements, risk tolerances, and accounting conventions. All else being equal, sponsors may prefer the option that involves the least exposure to credit risk. For example, the horizontal form of standard risk retention creates a fully subordinated residual interest that is more exposed to the expected losses of the deal than a similarly sized vertical form, and therefore is more sensitive to the deal's credit risk. By contrast, a vertical form of standard risk retention is comparable to a stand-alone pass-through securitization, which when held by the sponsor, is the form of risk retention least exposed to a deal's credit risk. As discussed below, some sponsors may choose to use the horizontal method of risk retention or some combination of the horizontal and vertical method in order to meet the risk retention requirement.

In particular, sponsors have an incentive to calibrate the level of risk exposure that minimizes their overall cost of funding. For example, some investors may be more likely to purchase senior ABS interests if the sponsor retains a larger residual interest and thus has more ''skin in the game.'' Alternatively, the sponsor may be unable to sell the residual interest on terms that would minimize the sponsor's cost of funding. In both instances, sponsors would prefer an option with a higher level of exposure to credit risk. This might be particularly true for securitizations that involve riskier or more opaque assets or more complicated securitization structures. As discussed previously, the potential need for retaining risk in a more costly form because the sponsor could not sell the residual interest on acceptable terms could be attenuated for registered offerings that are subject to the asset-level disclosure requirements under revised Regulation AB to the extent that investors are able to quantify risks using the required loan-level disclosures and are willing to purchase more of the residual interest on terms acceptable to the sponsor.

As the Commission discusses below, a number of the options also attempt to correspond to current market practices. By allowing sponsors to satisfy their risk retention requirement while still maintaining current market practices, the proposed menu of options approach should help to reduce additional costs of the required regime. Moreover, the flexibility sponsors have to design how they hold credit risk will allow them to calibrate and adjust their selections for each transaction according to changing market conditions.

On the other hand, because sponsors will have a choice on how to retain risk, their chosen structure may not always align interests and mitigate risks for investors in the same manner. Thus, to the extent that some forms of risk retention create disparate incentives for sponsors and investors,[438] the ability to rely on those options may not fully address some of the conflicts of interest that contribute to the moral hazard problem that characterize securitizations. In addition, the flexibility of this approach may increase the complexity of implementation of risk retention because of the wide range of possible choices available to sponsors.

a. Standard Risk Retention

The agencies are adopting the standard risk retention option as reproposed. In the reproposal, the Commission provided separate analyses of the economic effects of vertical risk retention, horizontal risk retention, or any combination of these two forms. Many commenters generally supported the reproposal to allow a sponsor to meet its risk retention obligation by using the standard risk retention option and approved of the flexibility that the proposal would provide to sponsors in structuring their risk retention. One commenter specifically expressed support for the single vertical security option, asserting that it would simplify compliance and monitoring obligations of the sponsor.

The agencies continue to believe that it is appropriate to provide flexibility to sponsors. This approach allows sponsors to minimize costs by selecting a customized combination of vertical and horizontal risk retention that suits their individual situation and circumstances, including relative market demand for the various types of interest that may be retained under the rule. To the extent that the costs and benefits of credit risk retention vary across time, across asset classes, or across sponsors, this approach would implement risk retention in the broadest possible manner such that sponsors may choose the combination of vertical and horizontal risk retention that they view as optimal. For example, if investors are unable to accurately estimate the risk of the securitized asset, the sponsor may be unable to sell the residual interest on acceptable terms, which would mean any excess vertical risk retention would be an additional cost to such a sponsor. Allowing flexibility will not only benefit sponsors but also will allow investors' demands to be more easily satisfied.

Below we discuss the economic implications of particular risk retention structures.

i. Eligible Horizontal Residual Interest

Under the eligible horizontal residual interest (EHRI) option, sponsors would hold the first loss piece, which as described above, would reflect a larger credit exposure than an equal percentage of retained risk using a form that included vertical retention. To the extent that such a holding signals to investors that the information about the asset portfolio being securitized is accurately represented and fairly priced, having this option available to sponsors may improve investor participation and lead to enhanced capital formation. However, horizontal risk retention used without vertical risk retention may not fully align sponsor incentives with the incentives of investors in all of the

[438] For example, if a sponsor is affiliated with a servicer (or has another way to influence the servicing of assets), then different forms of risk retention may change how distressed assets are serviced—more to the benefit of all investors or more to the benefit of junior tranche holders'. In most cases, investors in the more senior tranches would favor liquidation because liquidation of the securitized assets would reduce uncertainty and eliminate the credit risk of a delinquent or defaulted asset and because losses resulting from such liquidation of the securitized assets would be absorbed by investors in more subordinated tranches. Alternatively, investors in more subordinated tranches would favor a modification of the terms of a defaulted or delinquent asset because modification potentially could minimize losses.

tranches or classes. Investors who are investing in the most senior tranches will have different interests than the sponsor holding the residual interest, which is the most junior tranche, especially concerning the servicing of under-performing assets.[439]

There are several reasons why a sponsor may choose to hold a residual interest instead of a vertical interest. Sponsors may be unable to sell the residual interest or, if they are securitizing riskier loans, may hold the residual interest to increase investors' interest in more senior tranches. In particular, to the extent that a sponsor is willing to incur exposure to the first losses, investors may be willing to purchase the senior tranches at higher prices. Also, if sponsors have a cost of capital that is higher than the return provided by holding vertical risk retention, sponsors may choose to hold more subordinated tranches and more of the credit risk to generate a return sufficient to meet their required cost of capital. The holder of the residual interest generally receives a higher rate of return than any other tranche of the deal and therefore a sponsor may choose to hold horizontal risk retention in order to make the deal economically viable for the sponsor. This would increase the amount of capital available for riskier loans as sponsors' demand for loans of a higher risk increases. In all these cases, any requirement to retain a vertical interest would only impose additional costs on such sponsors.

In the reproposal, the agencies included cash flow restrictions with EHRI, reasoning that if sponsors can structure securitizations in such a way that the residual interest is able to receive cash early on in the deal then the sponsor's incentive to select loans with better underwriting may be reduced because the sponsor may be repaid all of their principal investment (''cash out of the deal'') before losses accumulate and the deal underperforms.

Many commenters supported elimination of the cash flow restrictions. They asserted that these restrictions are incompatible with a variety of securitization structures, that the certifications and disclosures to investors that would be required by the proposed cash flow restriction would create potential liability, and that there are possible ways around these restrictions such that they will not be meaningful but only increase costs to sponsors. Commenters also stated that cash flow restrictions would prohibit almost all securitizations from being issued as they are designed to pay high interest rates early on to the residual holder as compensation for risk taken, and that most of the structures in previously issued asset-backed securities would have failed the cash flow restriction tests. According to these commenters, imposing the cash flow restrictions could thus require current market participants to change their current practices, which could lead to a reduction or cessation of the securitization markets, resulting in a decrease in capital formation and reduction in allocative efficiency.

After considering the numerous comments received, the agencies have concluded that the proposed cash flow restrictions on the EHRI (as well as the alternative described in the reproposal and alternatives suggested by commenters) could lead to unintended consequences and impose unnecessary burdens on some asset classes. Therefore, the agencies have eliminated the previously proposed restrictions from the final rule. The revised disclosure requirements being adopted relating to the key inputs and assumptions underlying fair value calculations, however, should provide investors with the information necessary to analyze whether the sponsor is being conservative or aggressive in its estimate of the 5 percent risk retention holding. The rule also requires disclosure of the material terms of the residual interest. By providing this information to investors, the disclosure helps mitigate the concern that sponsors may provide accelerated returns to themselves through the residual interest since investors will be able assess the likelihood of such scenario based on this information. Eliminating the cash flow restriction requirements would eliminate the costs to sponsors associated with changing their market practice while potentially promoting competition among the sponsors for alternative structures that optimize their retention and investor preferences.

ii. Eligible Vertical Interest

A sponsor relying solely on the vertical option would hold a percentage of each tranche, resulting in an economic exposure of 5 percent of the credit risk of the entire loan pool. The primary benefit of vertical risk retention as compared to other standard forms of risk retention is that investor-sponsor incentives will be equally aligned across all ABS tranches.

Vertical risk retention is also subject to less credit risk exposure, and thus it will be a cheaper method for the sponsor to satisfy the requirement both in terms of cost of capital and in measurement and disclosure to investors. There is no requirement for sponsors to provide a fair value estimate to investors, which could reduce the cost of retaining risk relative to the costs associated with the other risk retention options. Vertical risk retention will be relatively simple for investors to evaluate because the sponsor will hold a specified percentage of each tranche. However, vertical risk retention may be less optimal for sponsors who typically hold a first loss piece with the intent of signaling higher quality of the senior tranches or for other reasons.

The benefits of the vertical form of risk retention extend to other market participants as well. By allowing sponsors to choose a vertical form of risk retention, there will be increased flexibility to choose higher yielding assets and provide greater access to credit to viable but higher-risk borrowers than would otherwise be possible through only a horizontal form of risk retention. Investors interested in holding residual interests will benefit from a vertical form of risk retention as they will be able to purchase more higher-yielding first loss pieces of securitizations, while investors who demand tranches above the first loss piece will have less supply available because the sponsor would hold 5 percent of each tranche instead of holding all of its retained risk in the residual interest.

The final rule also permits a single vertical security, as proposed. All economic considerations that apply to vertical risk retention will apply to the single vertical security except that the single vertical security may allow sponsors to comply with risk retention in a less costly manner in terms of administrative fees and accounting costs. If the sponsors' costs of risk retention are lower while still providing the same incentive alignment, then cost of credit for borrowers may be lower.

iii. Combined Risk Retention Option

The final rule allows sponsors to retain risk through any combination of a vertical form and a horizontal form provided that the total percentages of retained forms in the securitization add up to 5 percent. For example, a sponsor can hold 3 percent in the vertical form and 2 percent in the horizontal form in reliance on a combination of the horizontal and vertical forms of risk retention.

As noted above, horizontal risk retention allows sponsors to provide a stronger signal about their private information about asset quality than vertical risk retention because of the increased amount of credit exposure for

[439] *See* footnote 438.

sponsors. Hence, a sponsor choosing to retain risk in a more expensive horizontal form over a vertical form would have greater exposure to credit risk, and that sponsor's incentives should be better aligned with investors'. As previously described, by choosing a higher cost method of retaining risk, such as through the horizontal form, a sponsor can signal to the market greater certainty about the quality of assets and the level of risk in the senior tranches because the sponsor is willing to incur the losses in the lower subordination. However, the optimal size of the residual interest for a sponsor that seeks to maximize the proceeds and minimize the sponsor's overall cost of funding from securitization may not be 5 percent.

Finally, sponsors may choose to hold some residual interest in an attempt to gain a higher return on capital. In this case, again, the optimal size of the residual interest to achieve sponsor's required return may not be 5 percent. The combination of the horizontal and vertical forms reduces costs to sponsors by allowing them to hold some of their risk retention in the cheaper vertical form while still receiving credit for the residual interest they retain. Moreover, the vertical form of risk retention still allows for a more equal alignment of sponsors' interests with all types of investors because the sponsor will hold a portion of all of the tranches in the securitization.

Allowing a flexible combination of the horizontal and vertical forms accommodates various current market practices. Some asset classes have been able to monetize more of their exposure to securitized assets than other asset classes. Typically the range for RMBS has been closer to 1–3 percent of overcollateralization than to the 5 percent of fair value for the retained first loss piece required by the final rule. Thus, the flexible combination of horizontal and vertical forms will allow sponsors to continue to retain risk as they have in the past while keeping the cost of risk retention to a minimum.

The flexibility of the combination of the horizontal and vertical forms also allows sponsors to better meet demands of investors. If investors want to hold more of the residual tranche, the sponsor can hold less risk in the horizontal form and more risk in the vertical form to be able to sell interests in the residual tranche to investors. Alternatively, if there is a larger demand for more senior tranches, then sponsors can hold more risk horizontally. This flexibility will increase allocative efficiency within the ABS market. The flexible combination of the horizontal and vertical forms also increases competition among sponsors because it allows sponsors to adjust several dimensions of the securitization: risk retention costs, expected returns on retained pieces, and supply of tranches with different risk characteristics.

b. Options for Specific Asset Classes and Structures

i. Seller's Interest Option

The reproposed rule would have allowed a sponsor of a revolving master trust that is collateralized by loans or other extensions of credit to meet its risk retention requirement by retaining a seller's interest in an amount not less than 5 percent of the unpaid principal balance of the pool assets held by the sponsor. Commenters stated that the reproposed version of the seller's interest option would not accommodate all the common market practices in the master trust market. They suggested methods to broaden the options available to revolving master trusts to allow a wider variety of market practices to count as risk retention.

The agencies are revising the seller's interest option for revolving pool securitizations (referred to as revolving master trusts in the reproposal) in the final rule in order to accommodate more of the practices of sponsors that currently rely on revolving pool securitizations as an important component of their funding. These revisions recognize and accommodate the meaningful exposure to credit risk currently held by sponsors of these revolving pool securitizations, in light of the heightened alignment of incentives between sponsors and investors that attaches to their structural features. The agencies are also making a number of other refinements in the final rule in order to align the seller's interest option more closely with the mechanics of revolving pool securitizations as they are structured in the market today.

The *pari passu* seller's interest option in the final rule represents a special form of exposure to credit risk for the asset-backed security issued by a revolving pool securitization. Under this option, the sponsor must maintain the size of the seller's interest position, most commonly through the ongoing addition of receivables to the pool or repayment of investor ABS interests. Commenters also requested that the agencies accommodate other revolving pool securitizations that are common in the market and rely on a seller's interest that is structured in a different manner, which varies among the revolving pool securitizations used for certain asset classes. Commenters described two different structures, which the agencies believe should be recognized as an eligible form of risk retention under the final rule.

The agencies have recognized a series subordinated seller's interest in a revolving pool securitization as eligible risk retention in the final rule. As described by commenters, a series subordinated seller's interest is a common feature of revolving pool securitizations for certain asset classes, such as equipment leasing and floorplan financing. In these revolving pool securitizations, the sponsor is obligated, as is the case with the *pari passu* seller's interest, to maintain an undivided interest in the receivables in the collateral pool, in an amount equal to a specified percentage of the trust's outstanding investor ABS interests. Whereas the *pari passu* seller's interest is a trust-level interest equal to a minimum percentage of the combined outstanding investor ABS interests, the minimum percentage in subordinated seller's interest revolving pool securitizations may be tied to the outstanding investor ABS interests of each separate series. While the sponsor's right to receive distributions on the seller's interest included in the reproposal was required to be *pari passu,* the sponsor's right to receive distributions on its share of distributions in subordinated seller's interest revolving pool securitizations may be subordinated to varying extents to the series' share of credit losses.

Importantly, commenters noted that notwithstanding these differences with the *pari passu* seller's interest, the sponsor of a series subordinated seller's interest revolving pool securitization is still required to maintain the minimum amount of securitized assets in the pool, if the securitization is to continue revolving, through the ongoing addition of assets to the pool if necessary. The sponsor has incentives to monitor the quality of the assets added to the pool in both structures. If the sponsor replaces repaid or defaulted assets with poorly underwritten assets, those assets will, in turn, suffer losses, and the sponsor will be obligated to add even more assets. If this cycle is perpetuated and the minimum asset target is breached, the revolving pool securitization will enter an early amortization period, and the sponsor will no longer have access to future funding from the revolving pool securitization. Because the subordination of the seller's interest does not change this potential consequence and provides similar economic incentives as the *pari passu* seller's interest for the sponsor to

monitor and maintain the quality of securitized assets in the pool, the final rule recognizes this ''series subordinated'' form of seller's interest as an eligible form of risk retention for revolving pool securitizations. Allowing the series subordinated seller's interest accommodates existing market practice and will therefore minimize costs to certain revolving pool securitizations, while providing the intended benefit of aligning sponsor and investor incentives which will encourage higher quality underwriting.

Commenters also described another form of seller's interest used in revolving pool securitizations for certain asset classes, such as equipment leasing and floorplan financing, which are often collateralized by various types of ''excess'' receivables. The transaction documents for revolving pool securitizations typically impose eligibility requirements on the receivables that are allowed to be included as collateral for purposes of calculating the total amount of outstanding investor ABS interests that may be issued by the revolving trust. These eligibility requirements include concentration limits on receivables with common characteristics, such as those originating from a particular manufacturer or dealer or a particular geographic area. The sponsor places assets that exceed these concentration limits (ineligible assets) in the revolving pool securitization, where they are often subject to the pledge of collateral to the holders of the ABS interests, but they are not included when calculating the amount of the seller's interest under the revolving pool securitization. Distributions on these ineligible assets are typically allocated to the sponsor, but depending on the terms of the securitization, the sponsor's claim to the cash flow from these assets may be partially or fully subordinated to the claims of investor ABS interests, and these subordination features may be at the trust level, at the series level, or some combination of both.

While the agencies are persuaded that revolving pool securitizations should be allowed to hold these receivables without violating the common pool requirement, the final rule, consistent with market practice described above, does not allow these excess receivables to be included in the measurement of seller's interest. Because these are assets that by their terms are not representative of the assets that stand as the principal repayment source for investor ABS interests issued by the revolving pool securitization, the agencies believe, in conformance with market practice, that it would be inappropriate to include them in the calculation of the seller's interest. This accommodation for existing market practice allows a greater number of existing revolving pool securitization structures to meet the risk retention requirements, which should reduce the costs of compliance with the final rule and minimize disruption to existing structures. The agencies also recognize that some revolving pool securitizations make distributions on these receivables available to cover losses on eligible pool assets, which increases the amount of credit enhancement available to investors.

The agencies are adopting the seller's interest option generally as reproposed with certain modifications to incorporate more existing revolving pool securitizations. The Commission believes that there are several benefits to recognizing the existing seller's interests in revolving pool securitizations as an eligible form of risk retention. Aligning the rule's requirements with current market practice will reduce implementation costs for sponsors using the master trust structure while still retaining the benefits that investors receive through improved selection of underlying assets by the sponsors of revolving pool securitizations. Accommodating current practice will be transparent and easy for the market to understand and will preserve current levels of efficiency and help to maintain investors' willingness to invest in the market. Accommodating current practice will also provide clarity to market participants and may encourage additional investor participation given the removal of previous uncertainty about potential changes to current practices, thereby helping to promote capital formation. Under this option, there would be a cost to sponsors of measuring the seller's interest amount on an ongoing basis in accordance with the final rule, but since ongoing measurement is a current market practice, the additional cost should be low. Unlike more traditional securitization transactions collateralized by a static pool of assets, revolving pool securitizations use a single issuing entity to issue multiple series. These accommodations should allow sponsors of revolving pool securitizations to continue to use the same issuing entity and minimize the potential disruption to the market that could be caused by bifurcating the common pool of securitized assets or any other restructuring of the issuing entities, and any of their outstanding asset-backed securities issued prior to the applicable effective date of the final rule.

As discussed above, the agencies are modifying the seller's interest option to accommodate more of the market practices that currently exist. Accommodating more market practices will reduce costs for sponsors of revolving pool securitizations that otherwise would not been able to rely on the reproposed version of the seller's interest option and thereby help to promote competition within this segment of the market.

ii. Representative Sample

The agencies also considered the alternative option of risk retention held through a representative sample of the securitized assets that was proposed in 2011, but not included in the 2013 reproposal.

While some commenters were supportive of the original proposal's inclusion of the representative sample option, many commenters were critical of the option, stating that it would be impractical to implement this option for a variety of reasons, including that it would be unworkable for various asset classes, it would be subject to manipulation, and its disclosure requirements were too burdensome. Some commenters on the reproposal asked for the representative sample to be reinstated, asserting that a revised representative sample option would be particularly useful for automobile loan and lease securitizations, and more generally, for securitizations with large pools of consumer or retail assets, such as student loans. However, these commenters did not specify the costs of not including such an option in the final rule.

The agencies continue to believe a representative sample option should not be included in the final rule because, among other reasons, it would be difficult and potentially costly for investors and regulators to monitor or verify that exposures were indeed selected randomly, rather than in a manner that favored the sponsor. In order to allow sponsors to hold a representative sample, a number of material factors would need to be considered for the sample to be truly representative. However, even if many factors are considered, a factor could potentially be missed, and as a result, sponsors would end up holding a sample that differed in a material way from the pool assets. This could lead to ineffective alignment of incentives and therefore fail to realize one of the intended benefits of the rule. Due to these concerns, the agencies have decided not to include a representative sample option in the final rule. Sponsors using this structure will incur costs to comply with the requirements of the final rule because the final rule

does not include a representative sample option as one of the permissible forms of risk retention.

iii. Asset-Backed Commercial Paper Conduits Option

Under the reproposal, sponsors of ABCP conduits could either hold 5 percent of the risk using the standard risk retention option, as discussed above, or could rely on the ABCP option. The proposed ABCP option would not have required the sponsor of the conduit, which is typically a special purpose vehicle, to retain risk as long as the assets held in the ABCP conduit, which are often ABS interests in other asset classes, are not purchased in the secondary markets, and the sponsor of every ABS interest held by the ABCP conduit complies with the credit risk retention requirements. Another condition of the proposed conduit option was the requirement that the ABCP conduit have 100 percent liquidity support from a regulated institution.

Commenters generally repeated earlier requests that the agencies provide an exemption based on, or otherwise recognize, unfunded risk retention provided by banks in the form of liquidity support, program wide credit enhancement, unconditional letters of credit, and similar features, as satisfying the risk retention requirements. Commenters also requested that ABCP conduits relying on this option be permitted to use a broader range of transaction structures and purchase a wider variety of assets. Finally, some commenters suggested the elimination or modification of the proposed requirements to disclose fair value calculations and supporting information by conduit managers about an originator-seller's failure to comply with risk retention requirements, stating that such disclosure under current market conditions could risk the collapse of the particular ABCP conduit and pose a contagion risk to the other conduits.[440]

The agencies are adopting the ABCP option substantially as reproposed except for certain modifications based on comments received to accommodate a greater range of current market practices for existing ABCP structures in the ABCP option. The agencies have not adopted commenters' suggestion to permit the application of the ABCP option to certain types of assets not covered by the reproposal or transaction structures with less than 100 percent liquidity support. Restricting the option to ABCP conduits that hold only certain ABS interests is a structural safeguard that while possibly limiting the ability raise capital through ABCP conduits, will increase the alignment of incentives between sponsors of ABCP conduits and investors.

Under the final rule, eligible ABCP conduits may only purchase ABS interests in an initial issuance. By limiting an eligible ABCP conduit to holding ABS interests acquired in initial issuances, a sponsor will be in a better position to potentially influence the terms of the deal and have an effect on the quality of assets underlying the ABS interests relative to if the ABS interests were acquired in the secondary market post issuance. However, by conditioning ABCP conduit eligibility to rely on the ABCP option on the purchase of ABS interests in an initial issuance, the rule could have a negative impact on secondary markets, possibly resulting in lower liquidity and potentially decreasing the efficiency in the secondary markets for ABS interests. Additionally, the agencies understand that ABCP conduit structures that primarily relied on secondary market purchases (arbitrage ABCP conduits) performed poorly during the financial crisis.

Allowing the ABCP option provides incentive to improve underwriting while minimizing the impact on ABCP funding costs, thereby lessening the potential burden on capital formation as ABCP conduit sponsors will not need to use their capital to retain 5 percent of the ABS interest issued by the ABCP conduit. The risk retention option for ABCP conduits includes specific requirements for a regulated liquidity provider that provides liquidity support with contractual terms that meet certain requirements. We estimate that approximately half of existing ABCP conduit sponsors may need to adjust the terms of their existing liquidity support in order to comply with the requirements of the final rule, and therefore will incur costs to implement the liquidity support necessary to meet the new requirements. The liquidity support requirements are largely consistent with the exclusion from the definition of covered fund for certain ABCP conduits in the rules implementing Section 619 of the Dodd-Frank Act. As a result, the Commission believes ABCP conduits sponsored by banks, which make up the bulk of the ABCP market,[441] already have or will have liquidity support that will comply with the final rule, and therefore the new requirements will not materially increase their costs.

Maintaining current practice and requiring 100 percent liquidity coverage without regard to asset performance will be transparent and easy for investors to understand and implement, and help to maintain investor's willingness to invest in ABCP. Adoption of the liquidity coverage requirement and removal of previous uncertainty about liquidity coverage (*i.e.* under what conditions liquidity support would be provided) should also provide clarity to investors and may encourage additional investment, thereby lowering the cost, or increasing the amount, of capital formation in ABCP and underlying asset-backed securities markets. However, the liquidity support could have the effect of lowering the yields of the ABS interests because investors will face less risk compared to less than 100 percent liquidity support.

Other modifications that the agencies are making will also permit more existing market practices to be used with the ABCP option. Accommodating these market practices will reduce costs to those ABCP conduits that were not covered under the reproposed version of the ABCP option and thereby help to promote competition within this segment of the market.

iv. Commercial Mortgage-Backed Securities Option

The agencies are adopting the CMBS option largely as reproposed. The Commission continues to believe that the option provides a means to satisfy the risk retention requirements that, for the most part, will allow CMBS issuers to continue current market practice relating to techniques that align incentives and improve underwriting standards. Under the final rule, a sponsor will be able to satisfy the risk retention requirements by having up to two third-party purchasers (provided that each party's interest is *pari passu* with the other party's interest) purchase an eligible horizontal residual interest (B-piece) in the issuing entity if it is backed solely by commercial real estate loans and servicing assets. The third-party purchaser(s) would be required to acquire and retain an eligible horizontal residual interest in the issuing entity in the same form, amount, and manner as the sponsor (with the same hedging, transfer, and other restrictions) except that after five years the third-party

[440] The Commission believes that the diversification of ABS interests and the 100 percent liquidity support requirement make this scenario highly improbable.

[441] Asset-Backed Alert, March 28, 2014, lists the 20 largest ABCP conduit administrators. All but one of them are large banks. The non-bank is Lord Securities.

purchaser can sell the B-piece to another eligible third-party purchaser.

As discussed in Section 3.b.ii of this Economic Analysis, currently the B-piece investors in CMBS often hold dual roles as bond investors, if the assets remain current on their obligations, and as holders of controlling interests to appoint special servicers, if the loans default and go into special servicing. The B-piece investors are typically real estate specialists who use their extensive knowledge about the underlying assets and mortgages in the pools to conduct extensive due diligence on new deals. Such due diligence is feasible because typically CMBS have much smaller number of underlying loans in a pool.[442] Consequently, since B-piece buyers are taking the credit risk and have an ability to perform their own due diligence on securitized assets before purchasing the residual tranche, the third party holding risk effectively serves as an independent re-underwriter of the underlying loans, achieving a quality of re-underwriting consistent with the quality of underwriting of a sponsor that would retain credit risk on its own balance sheet. B-piece buyers also have the ability to affect the performance of the securitization when problems arise. Because they usually have expertise in commercial real estate and are holders of controlling interests to appoint special servicers (and often have special servicers affiliates), they facilitate restructuring of underperforming loans to maintain the structure of a CMBS. By providing for the continued retention of risk and strong incentive to the sponsor to limit potential moral hazard problems at the time the structure is put in place, the effect of the CMBS risk retention option on the moral hazard problem will likely be similar to the effect of one of the standard risk retention options.

Allowing the third-party purchaser to sell the B-piece to another eligible third-party purchaser after a minimum holding period should generate secondary market liquidity, thereby lessening the original purchaser's cost of retaining the risk and encourages greater participation in the CMBS market by eligible B-piece purchasers. The resulting secondary market transactions could generate additional benefits to CMBS investors to the extent that B-piece buyers have differential skills with respect to assessing the risk at the time of origination, monitoring performance, and engaging in restructuring activity when performance issues arise. Allowing the transfer of the B-piece will allow the transfer of the B-piece to a purchaser with specialized skills appropriate to the particular situations.

Under the final rule, use of the CMBS option requires the appointment of an independent operating advisor who, among other obligations, has the authority to recommend and call a vote for removal of the special servicer under certain conditions. This requirement may serve to limit potential conflicts of interest between the investors in senior tranches and the B-piece buyer(s), thus helping to ensure that the benefits of the risk retention requirements are preserved and extended to all investors. There will be costs, however, related to the appointment of the independent operating advisor, including, but not limited to, the payments to the advisor.[443]

The primary benefit of allowing sponsors to maintain their current market practices is to effectively achieve the intended objectives of risk retention with minimized cost to the CMBS market. Commenters generally supported the CMBS option as reproposed, with one investor commenter cautioning against further modifications to the proposed CMBS option, expressing the view that CMBS underwriting standards were beginning to deteriorate. However, some comment letters suggested changes from the reproposal.

Commenters suggested increasing the 5 percent minimum quorum requirement for a vote to replace the special servicer to 15 percent or 20 percent, and adding a requirement that no fewer than three unaffiliated investors participate in the vote. The agencies have decided to permit CMBS transaction parties to specify in the underlying transaction documents the quorum required for a vote to remove the special servicer, provided it is not more than 20 percent of the outstanding principal balance of all ABS interests in the issuing entity, with such quorum including at least three ABS interest holders that are not affiliated with each other.

The final rule includes these suggested changes to address the concern that a 5 percent quorum could allow a B-piece buyer holding 5 percent of the CMBS deal to replace the special servicer alone without consent of other investors. As discussed in Section 3.b.ii of this Economic Analysis and in Part III.B.5 of the Supplementary Information, the B-piece investors in CMBS often have an affiliate special servicer and, as holders of controlling interests, they can appoint that affiliated entity if the loans default and go into special servicing. An affiliate special servicer could make decisions about loan restructuring in the interest of its affiliated B-piece holder that are inconsistent with the interests of all investors. Thus, requiring at least three investors that are not affiliated with each other for the quorum would ensure that the economic interest of at least some senior tranche investors would be accommodated in the selection of the special servicer and subsequent restructuring.

Raising the maximum quorum requirement to 20 percent from 5 percent in the final rule will further ensure that other CMBS investors will participate in the selection of the special servicer. Limiting the maximum quorum requirement to 20 percent also ensures that investors do not face an undue burden in coordinating with other dispersed investors to call a vote to change the special servicer. Currently, transaction agreements can stipulate any quorum threshold. If a transaction agreement currently stipulates a threshold that is too high, the coordination costs attributed to collective action could prevent potentially efficient changes in the special servicer. On the other hand, with less ability to influence the selection of the special servicer, combined with an inability to disinvest until the expiration of the sunset period, B-piece buyers will have less incentive to invest in B-pieces. Hence, relative to current practices, mandating a lower maximum quorum requirement could generate benefits in some cases.

The agencies considered but did not adopt the suggestion to allow third party purchasers to hold their interests in a senior/subordinate structure, rather than *pari passu,* to match the risk of loss of each B-piece interest and the risk tolerances of each B-piece buyer. Commenters asserted that a senior-subordinated structure would better allow the market to appropriately and efficiently price the B-piece interests in a manner that is commensurate with the risk of loss of each interest, and to address the different risk tolerance levels of each third-party purchaser. However, other commenters strongly opposed allowing third-party purchasers to satisfy the risk retention requirements through a senior-subordinated structure, commenting that such a change would significantly

[442] *See also* footnote 424.

[443] According to CRE Finance World, Autumn 2012, Volume 14, No.3, pp. 47–50, the operating advisor fee rate is ''modest.'' Other costs may include delays in special servicer replacement due to the need to call for investors' vote, and a possible loss of efficiency because operating advisors may be less knowledgeable of the special servicing market than B-piece buyers.

dilute and render ineffective the risk retention requirements. The agencies have decided not to allow third-party purchasers to satisfy the risk retention requirement with a senior-subordinated structure. As noted earlier, the purpose of third-party risk retention is to create a transaction participant that would serve as an independent re-underwriter of the underlying loans. A ''senior'' B-piece holder in this structure might not be appropriately compensated for employing sufficient resources to re-underwrite a CMBS transaction because its expected return would be too low to compensate for the expenditure of resources necessary for re-underwriting. In addition, the *pari passu* requirement better aligns the interests of the most junior tranche buyer(s) with those of more senior noteholders whereas the senior/subordinated structure for the B-piece would further separate the interests of most junior tranche buyer(s) (that in this case could hold the first loss tranche that might be significantly smaller than 5 percent) from those of the senior noteholders, which could exacerbate conflicts of interest issues in this area.

Some commenters opposed the disclosure of the purchase price paid by third-party purchasers for the eligible horizontal residual interest. These commenters pointed out that such information has traditionally been viewed by all market participants as highly confidential and proprietary, and that the disclosure requirement would deter B-piece buyers from retaining risk. The Commission acknowledges that, if B-piece buyers are deterred from purchasing eligible residual horizontal interests, this could lower the liquidity of the junior tranches of CMBS and, thus, potentially increase the sponsors' cost of capital and the cost of credit for borrowers. However, the agencies continue to believe that requiring disclosure of the price at which the B-piece is sold is important to understanding the value of the third party's risk retention (and therefore whether the required amount has been retained) and would be consistent with other required fair value disclosures for any eligible horizontal residual interest retained by the sponsor that allow investors to assess the amount of risk being retained.[444] Hence, the ability of investors to quantify the amount of credit risk exposure of the B-piece buyer, and thus the level of incentive alignment with other investors, generates benefits that would not be possible if B-piece buyers were able to keep the price confidential.

The final rule provides additional flexibility for the CMBS option by allowing up to two third-party purchasers to satisfy the risk retention requirement. This provision accommodates the current market practice[445] and should facilitate liquidity of the residual piece market, contributing to a lower cost of capital for sponsors and borrowers. While commenters generally supported allowing up to two third-party purchasers to hold risk retention, one commenter recommended expanding the number of third-party purchasers to allow participation by more than two B-piece investors. The agencies do not believe it would be appropriate to allow more than two third-party purchasers in a single transaction. While allowing more than two purchasers could increase B-piece market liquidity and, in turn, reduce costs for CMBS sponsors, it also could dilute the incentives generated by the risk retention requirement to monitor the credit quality of the commercial mortgages in the pool, thereby undermining the intended benefits of the rule. Each B-piece investor who has exposure to significantly less than 5 percent credit risk, would have not enough ''skin in the game'' to be incentivized to monitor the quality of underwriting as discussed in Section 4.a.i. of this Economic Analysis.

v. Government Sponsored Entities Option

The final rule allows the full guarantee of the Enterprises under conservatorship or receivership to count as risk retention for purposes of the risk retention requirements. Because of the capital support provided by the U.S. government for the Enterprises, investors in Enterprise ABS are not exposed to credit loss, and there is no incremental benefit to be gained by requiring the Enterprises to retain risk.

Commenters generally supported allowing the Enterprises' guarantee to be an acceptable form of risk retention in accordance with the conditions proposed and did not suggest any alternatives. The agencies are adopting the Enterprise option as reproposed.

This option along with the Enterprises' capital support from the U.S. government creates a competitive advantage for the Enterprises over private-sector sponsors when purchasing non-QRM loans as long as they are conforming to the Enterprises underwriting standards. Recognizing the Enterprises' guarantee as fulfilling their risk retention requirement and the resulting additional competitive advantage over sponsors of non-QRM conforming loans has two significant economic benefits. First, it will allow the Enterprises to facilitate the availability of capital to segments of the population that might not otherwise have access through private sector channels. Second, it will provide stable funding of home financing in periods when lenders curb their lending due to limited access to capital and private-sector sponsors are unable or unwilling to meet excess demand.

A potential cost of recognizing the Enterprises' guarantee as fulfilling their risk retention requirement is that it may incentivize them to purchase loans that do not meet the QRM criteria (*i.e.,* expanding the Enterprises' conforming loans underwriting criteria), which would introduce risk that the risk retention requirement is intended to mitigate. However, analysis of loans originated between 1997 and 2009, a period that spans the onset of the financial crisis, shows that private label loans had a much higher serious delinquency rate than Enterprise purchased loans, even after accounting for different underlying loan characteristics.[446] Hence, this historical performance-based evidence suggests that Enterprise underwriting standards may offset any incentive to incur excess risk because of their capital support, at least in relation to the incentives and behaviors among private label sponsors during the same period.

If the Enterprises' conservatorship is terminated, their securitizations will no longer be exempt from risk retention requirements unless the securitized assets meet the QRM definition. This will put the Enterprises on even footing with private label securitizations in terms of risk retention, but, as was the case before the crisis, the Enterprises still carry an implicit guarantee of the U.S. government and, thus, will retain some of their funding advantage for both QRM and non-QRM securitizations. Private label securitizations may still have limited ability to be a significant source of capital to conforming non-QRM loan originations until the Enterprises wind down their activity or the implicit guarantee is eliminated. As is the case now, private label

[444] *See* Section 4.a.ii of this Economic Analysis.

[445] Based on Commercial Mortgage Alert, out of 61 private label U.S. CMBS deals in 2013 that had B-piece buyers, 50 had a single B-piece buyer, 12 had two B-piece buyers, and none of the deals had more than two B-piece buyers.

[446] *See* Joshua White and Scott Bauguess, *Qualified Residential Mortgage: Background Data Analysis on Credit Risk Retention,* (August 2013), *available at http://www.sec.gov/divisions/riskfin/whitepapers/qrm-analysis-08-2013.pdf.*

securitizations would not have to compete with the Enterprises for securitizations of non-conforming loans (*e.g.,* riskier non-qualified mortgage (non-QM) loans or jumbo loans), which will still fall outside of the Enterprises domain if current conforming loan underwriting standards remain in place.

vi. Open Market Collateralized Loan Obligations

A collateralized loan obligation (CLO) is an asset-backed security that is typically collateralized by portions of tranches of senior, secured commercial loans or similar obligations of borrowers who are of lower credit quality or that do not have a third-party evaluation of the likelihood of timely payment of interest and repayment of principal. Commenters distinguished between two general types of CLOs: open market CLOs and balance sheet CLOs. As described by commenters, a balance sheet CLO securitizes loans already held by a single institution or its affiliates in portfolio (including assets originated by the institution or its affiliate). An open market CLO securitizes assets purchased on the secondary market at the direction of an asset manager, in accordance with investment guidelines. Under the final rule, sponsors of CLOs are required to retain 5 percent of risk using the standard form of risk retention and have not been provided with an exemption from the rule's requirements. CLOs are subject to the same sunset provisions as other non-residential mortgage securitizations.

As an alternative to this standard risk retention, the agencies are adopting, as proposed, an option for sponsors of open market CLOs to satisfy the risk retention requirement by holding only ''CLO-eligible'' tranches for which the syndicated loan's ''lead arranger'' retains (for the duration of the loan) at least 5 percent of the tranche's value. A syndication's ''lead arranger'' is defined as a syndicated member that holds an initial allocation of the overall syndicated credit facility equal to (at least) the greater of (a) 20 percent of the aggregate principal balance and (b) the largest allocation taken by any other member (or members affiliated with each other) of the syndication group. The agencies have defined open market CLOs for purposes of the lead arranger option being adopted. The analysis below considers the impact of the risk retention requirements and the lead arranger option on the market for open market CLOs, which was the subject of many comment letters.[447]

Under the final rule, the risk retention requirements for open market CLOs are subject to the same sunset provisions as other non-residential mortgage securitizations. These provisions require CLO sponsors to retain risk until the latest of: (1) The date on which the principal balance of the securitized assets reduces to 33 percent of the original unpaid principal balance as of the cut-off date or similar date for establishing the composition of the securitized assets collateralizing the asset-backed securities issued pursuant to the securitization transaction, (2) the date on which the unpaid principal obligations of securities has been reduced to 33 percent of the original unpaid principal obligations at the closing of the securitization transaction, or (3) two years after the date of the closing of the securitization transaction.

The loans backing CLOs typically have maturities that can extend beyond the term of the CLOs, particularly when the loans are added to the pool after issuance, which could mean that loan balances of loans held by a CLO may not necessarily decrease prior to the maturity or redemption of the CLO. Hence, the final rule may effectively require the CLO manager (as the sponsor of the CLO) to retain risk beyond the minimum sunset period. This should lessen the incentive for managers to alter the composition of the loan portfolio in a way that could harm investors relative to what may be present with a shorter sunset period.

A key difference between this lead arranger option and those related to, for example, commercial mortgage backed securities is that the CLO manager must rely on the lead arranger's continuing 5 percent retention of risk in the CLO-eligible loans, in order for the CLO manager to satisfy its risk retention obligations. Thus, unlike a portfolio of commercial mortgages, the CLO requirement extends beyond the initiation date of the securitization so that the status of the lead arrangers' continuing participation may affect the CLO manager.

The agencies received many comments about the lead arranger option, and the impact of risk retention on the market for open market CLOs. These comments can be categorized into four main areas: (1) The impact of the lead arranger option on the availability and cost of leveraged loans; (2) the unwillingness or inability of arrangers to create CLO-eligible tranches; (3) alternative options for sponsors of open market CLOs to retain risk; and (4) general concerns about the impact of risk retention on the CLO industry and the syndicated loan market.

Regarding the impact of the lead arranger option on borrowing costs, commenters asserted that the proposed option would be unworkable with existing CLO practices and therefore the risk retention requirements would result in a significant reduction in CLO issuances and a corresponding reduction in credit to commercial borrowers. Commenters further asserted that the requirement that the lead arranger retain at least 5 percent of an eligible tranche would increase the required capital and FDIC assessment charges, thereby increasing the pricing of CLO-eligible tranches, and adversely impacting borrowing costs. Moreover, some commenters noted that only a very small number of arrangers can meet the definition of ''lead arranger'' as proposed, because the syndication of leveraged loans is concentrated among a small number of banks.[448] According to these commenters, requiring lead arrangers to hold a relatively large piece of these syndicated loans on their balance sheets would cause a substantial increase in their risk-based capital requirement.[449] Further, commenters noted that the requirement to retain 5 percent of the eligible tranche, combined with the hedging and transfer restrictions, is inconsistent with sound risk management practices, overly burdensome in light of regulatory and lending limits and would reduce the lead arranger's ability to extend credit. Commenters also stated that these additional costs, imposed on the lead arranger, would be passed on to the corporate borrowers, restricting access to and cost of capital.

One commenter observed that only a handful of non-regulated entities have a sufficient amount of available capital to arrange and syndicate leveraged loans and satisfy the proposed risk retention requirements under the lead arranger option. According to this commenter, adopting the lead arranger option, as

[447] In balance sheet CLOs the originator of the loan is the sponsor or an affiliate of the sponsor. For balance sheet CLOs, economically there is no difference between the lead arranger option and standard risk retention when the sponsor is the originator or its affiliate.

[448] Based on Bloomberg L.P. data, the largest five banks arranged 47 percent of the syndicated leveraged loans in 2013.

[449] One commenter pointed out that banks and other highly regulated financial entities represent almost the entire market of originators of the loans that comprise the assets collateralizing CLOs. This commenter stated that the requirement for lead arrangers to hold additional exposure to a borrower that is unhedged until maturity of the loan is generally inconsistent with prudent lending practices and internal lending policies. Such a requirement also, impacts the amount of other banking products that such lead arrangers can extend to other borrowers.

proposed, would cause a severe contraction in CLO-related activities by regulated institutions and a significant reduction in liquidity to a critical sector of the U.S. economy. The Commission notes, however, that this conclusion assumes that other lenders will not enter the market with sufficient capital to compensate for the loss of bank capital in the event that large banks curtail their involvement in the CLO sector. For example, other commenters asserted that if the risk retention requirement caused a reduction in participation by open market CLOs in the leveraged loan market, other institutions would enter the market to fill the unmet credit needs. Ultimately, if this were to occur, the commenters asserted that non-CLO credit providers likely would incur higher costs than the CLO credit providers that have operated in the past, and these costs would be passed along to the ultimate borrowers, raising their cost of funding.

Commenters' second main area of concern was the practical ability and willingness of originators to create and retain CLO-eligible tranches. One commenter stated that the lead arranger option is not workable because the implementation difficulties associated with creating CLO-eligible tranches are substantial and observed that surveyed banks have indicated they would not be willing to take on this endeavor. In particular, to qualify for the option, CLO-eligible tranches would be required to carry separate voting rights, which the same commenter asserted would be administratively unworkable and commercially unacceptable to the other parties to the loan transaction. Commenters also expressed concern that it was unclear how a CLO would be able to monitor whether the CLO-eligible loan tranche continues to meet the necessary criteria. Commenters stated that the requirement that a lead arranger represent that the loans continue to meet the rule's criteria exposes the lead arranger to potential liability that the lead arranger cannot realistically bear. While the Commission acknowledges these concerns, the Commission also notes that, because CLOs are a major source of funding for leveraged loan originators, there is significant economic incentive for arrangers to use the lead arranger option to ensure the continued participation of CLO managers.

Other commenters argued that open-market CLOs should be exempted from the risk retention requirements altogether because the organizational structure of open market CLOs provides investors with sufficient safeguards. These commenters indicated that open market CLOs operate independently of originators and are not part of, and do not pose the same risks as, the originate-to-distribute model. They also asserted that CLO managers' interests are fully aligned with the interests of CLO investors because CLO managers bear significant risk through their deferred, contingent compensation structure, which they noted is based heavily on performance of the underlying assets. Commenters also noted that most CLO managers are registered investment advisers, with associated fiduciary duties to their clients. Commenters also noted that many CLO managers are subject to existing regulations that provide meaningful protections against imprudent or inferior underwriting, including the leveraged lending guidance released by the Federal banking agencies in 2013.[450] Commenters further asserted that existing industry best practices mitigate risks, and that CLO assets are actively managed and often include select senior secured commercial loans with investor protection features. More generally, commenters asserted that: (1) unlike many other securitizations, CLOs are securitizations of liquid assets and are structurally transparent, (2) CLOs have historically performed well even during the financial crisis, and (3) this strong performance is evidence that risk retention is unnecessary.

Some commenters proposed a new option for ''qualified CLOs'' that would codify many of the existing practices of open-market CLOs and require CLO managers to hold 5 percent of the equity tranche of at least 8 percent of the value of the CLO. As discussed below, the Commission does not believe this option would provide sufficient incentive alignment for open-market CLOs. Although some commenters stated their belief that CLO managers select and manage CLO assets free from the potential conflicts and misaligned incentives related to the originate-to-distribute model, the Commission notes that, without a risk retention requirement, there is little economic incentive to discourage practices associated with an originate-to-distribute model from developing.

The fourth category of comments reflected a general concern about the lead arranger option and the impact of risk retention on the market for open market CLOs. One commenter expressed concern that designating one tranche of a syndicated facility the CLO-eligible loan tranche would significantly affect the pricing of other tranches due to the decreased liquidity of such tranches, as such tranches would not be available for securitization in the CLO market. The same commenter noted that the universe of CLO-eligible loan tranches would be very limited and restrict the CLO manager's ability to invest in a diverse number of loans. Further, several commenters asserted that the costs of imposing risk retention on CLO managers exceeds the benefits and that the agencies have not performed an adequate economic analysis in connection with the lead arranger option.

One study by Oliver Wyman[451] claimed that as a result of the proposed requirements, credit spreads will increase from 117 to 292 basis points and costs to borrowers will increase between $2.5 billion and $3.8 billion per year because non-CLO lenders will charge a higher interest rate to leveraged loan borrowers than CLOs. To arrive at these estimates, the study assumed that CLO managers unaffiliated with a large financial institution or market participant will no longer be able to provide capital to the leveraged loan market and that credit would not be provided to borrowers through other channels.

In reaching these conclusions, the study makes several assumptions that are questionable. For instance, the study assumes that CLO managers cannot or will not be able to hold 5 percent risk retention. However, the Commission believes that there may be economically feasible means for CLO managers to meet the risk retention requirements, particularly if there is economic incentive of the magnitude described in the study (*i.e.,* predicted spread increases ranging from 100 to 200 basis points). Another assumption is that not enough lead arrangers will use the lead arranger option which will mean there

[450] *See Leveraged Lending Guidance.* However, as discussed above in Part III.B.7 of the Supplementary Information, the Federal banking agencies noted that there is evidence that increased activity in the leveraged loan market has coincided with widespread loosening of underwriting standards and that many banks have not fully implemented standards set forth in the guidance, see Semiannual Risk Perspective: Spring 2014, Office of the Comptroller of the Currency, at 5 (June 2014), available at *http://www.occ.gov/publications/publications-by-type/other-publications-reports/semiannual-risk-perspective/semiannual-risk-perspective-spring-2014.pdf,* Shared National Credits Program: 2013 Review, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency (September 2013), available at *http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131010a1.pdf* and ''Fed Scrutiny of Leveraged Loans Grows Along With Bubble Concern'', Bloomberg News, October 1, 2014, available at *http://www.bloomberg.com/news/2014-10-01/fed-scrutiny-of-leveraged-loans-grows-along-with-bubble-concern.html.*

[451] *http://www.sec.gov/comments/s7-14-11/s71411-535.pdf.*

will not be enough CLO-eligible tranches for CLOs to be formed using the lead arranger option. Given that CLOs currently account for a significant portion of the leveraged loan market, there are significant economic incentives for loan arrangers to create CLO-eligible tranches particularly because, by not doing so, originators may not have enough demand for their issuances. Hence, lead arrangers may make CLO-eligible tranches available, which would create enough diversification and supply for CLOs to rely on the lead arranger option.

The study's third assumption relies on an estimate of elasticity of supply of credit in the leveraged loan market (*i.e.,* the change in the availability of credit associated with a given change in the loan interest rate). The study proxied for the elasticity of supply of credit with an estimate of elasticity of demand for credit in the leveraged loan market (*i.e.,* the change in the borrowers' demand for credit associated with a given change in the loan interest rate) published in another (academic) study.[452] However, the commenter's study does not justify its assumption that the elasticity of supply should be equal to the elasticity of demand. Indeed, the commenter's study implicitly assumes that demand is inelastic and would not change in response to the change in interest rate (*i.e.,* that borrowers would demand the same amount of credit regardless of the level of interest rates). The commenter's study also assumes that the credit supply curve would not shift in response to the change in interest rate (*i.e.,* as a result of entrance of new lenders).[453] Taken together, the Commission believes the assumptions in the commenter's study contribute to an estimate of the cost to the leveraged loan and the CLO industry that is likely to be significantly inflated.

More generally, there are several considerations that could affect the extent of the rule's impact on the leveraged loan market, as described in the commenter's study. One consideration is that non-CLO investors might invest more capital given the right incentives (higher yields or less risk). These investors include hedge funds, loan mutual funds, and insurance companies. Another possibility is that these investors, instead of purchasing leveraged loans on the secondary market, would join in as part of the syndication. Finally, CLO managers with lower cost of funds and capability to satisfy the risk retention requirements may replace some of the supply of credit lost due to exit from the market of CLO managers with higher cost of funds. Any of these possibilities would mitigate the loss of CLO capital as other investors invested more capital into the leveraged loan market.

Although the Commission acknowledges commenters' concerns about the lead arranger option, the Commission does not believe there is an economic justification for an exemption from the standard 5 percent risk retention requirement for CLOs. The Commission believes that the amount of risk retention included in the alternative approach suggested by commenters of a CLO option retaining 5 percent of the equity tranche of at least 8 percent of the value of the CLO transaction (effectively amounting to as low as 0.4 percent risk retention in the entire securitization) would not sufficiently address the originate-to-distribute risks in the leveraged loan market. In particular, a CLO market absent of meaningful risk retention may not have the protections against future moral hazard problems that the final rule is designed to provide. The Commission acknowledges that risk retention may generate significant upfront costs to the CLO and the leveraged loan market relative to current practices or the proposed alternatives provided by commenters. However, the Commission believes that these current practices and the proposed alternatives would not do enough to align incentives between sponsors and investors which, in the long term, could impose larger costs on the market than the risk retention requirements of the final rule.

The Commission is also sensitive to the claim by commenters that the CLO market performed well during the financial crisis in comparison to other asset classes and, in particular, to RMBS. However, the Commission believes that this claim has the benefit of hindsight, and that during the financial crisis, there were considerable concerns with the ability of borrowers to meet their financial obligations through their collateralized loans.[454] Ultimately, aggressive monetary policy resulted in sharp declines in the interest rates payable on floating-rate leveraged loans, making it easier for borrowers to meet their loan obligations. The Commission believes that it is this extraordinary influence on borrowing costs, and not the underlying market practices of CLO managers, which largely explains CLO performance during the financial crisis. Hence, CLO performance during the financial crisis does not provide a sound basis for an exemption from the rule's requirements.

The Commission believes that commenters' alternative suggestions do not create sufficient incentive alignment, or ''skin in the game,'' for sponsors to ensure that originators maintain high underwriting standards in accordance with the purposes of Section 15G. While the Oliver Wyman study claims that risk retention will have a large negative impact on the leverage loan market and the CLO industry, the Commission believes that the assumptions underlying that assessment are questionable. In particular, the study assumes that CLO managers, who currently hold 53 percent[455] of the leveraged loans sold by originators, will no longer be able to purchase leveraged loans and that a significant proportion would otherwise go unfunded. The Commission acknowledges that this may increase cost to leveraged loans borrowers, but, for the reasons explained above, the Commission believes these are likely to be at a much lower level than the study suggests. Originators may sell leveraged loans to other purchasers, in which case, as discussed below, smaller CLO managers may be affected but there would not be a significant impact on the CLO market.

Under current practices in the leveraged loan market, syndicates hold the revolving piece of the origination, which is a line of credit that allows the borrower to drawdown additional capital from the arranger. Hence, the revolving piece of a leveraged loan represents a potential future liability to the lead arranger that could ultimately increase the amount of risk retained. The agencies did not create an option for treating this future liability as retained risk. In this way, the final rule may result in the lead arranger holding more exposure to the borrower of the leveraged loan than what would be required to satisfy the risk retention

[452] Greg Nini, ''Institutional Investors in Corporate Loans'', University of Pennsylvania working paper, 2013, available at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2349840.*

[453] The study asks the question ''How much ''extra'' yield would be needed to induce these non-CLO loan buyers to increase the amount of credit they are willing to supply?'' and proceeds to estimate ''the increase in credit quantity that non-CLO leveraged loan credit providers would have to supply to fully replace lost CLO capacity.''

[454] *See, e.g.,* Ng, S., and K. Haywood, 2009, ''Rates Low, Firms Race to Refinance Their Debts,'' The Wall Street Journal, June 26, 2009, *http://online.wsj.com/articles/SB124597520948957427.* They observe: ''Bankers and borrowers alike worry that the overhang could create serious problems in the years ahead if financial markets don't heal enough to allow hundreds of non-investment-grade companies to refinance their debt.''

[455] *See* Bloomberg Business Week, January 1, 2014, available at *http://www.businessweek.com/news/2014-01-31/leveraged-loan-trades-in-u-dot-s-dot-rise-to-most-since-07-lsta-says.*

requirement. Therefore, allowing the lead arranger to hold risk retention in place of the CLO manager should not diminish, and may increase, the alignment of incentives between loan arrangers and ultimate investors in the CLO, by providing strong incentives for the loan arranger to create loans with high underwriting standards.

The impact of the lead arranger option on the leveraged loan market will be determined by the likelihood that lead arrangers are willing to retain risk in the manner required and CLO managers are willing to rely on this commitment. As commenters stated, there are frictions in the market that may prevent CLO managers from purchasing CLO-eligible loans or originators from creating CLO-eligible tranches. CLO managers may not be able to ensure that the bank will meet the CLO-eligible tranche requirements for the length of the loan. In addition, the special voting rights attached to the CLO-eligible tranche may prevent other parties from wanting to create a CLO-eligible tranche.

Large commercial banks are the primary source for leveraged loan origination and may be reluctant to retain ongoing exposure to leveraged loans because the loans are typically longer term and riskier than the other assets banks usually hold on their balance sheet. As such, they may not be willing to serve as a lead arranger for the purpose of creating a CLO-eligible tranche. Should these banks choose to create CLO-eligible tranches to facilitate additional demand for their originations, it is possible that they would charge borrowers higher rates to compensate for the additional capital charge they could incur under existing regulatory requirements, or because it would impede a redeployment of capital for other projects.

CLO managers that use the lead arranger option will be relying on lead arranger commitments to hold 5 percent of the CLO-eligible tranche for the duration of the loan. A CLO manager relying on the lead arranger option would need to sell any tranches that cease to be CLO-eligible tranches due to the failure of a loan arranger to hold the required amount of risk, which could generate an otherwise unnecessary loss if the forced sale provides a buyer with leverage to negotiate a discount. However, a CLO manager should have some level of confidence in a lead arranger's ongoing commitment to meet the requirement because there will be recourse against the lead arranger for breach of contract, as the lead arranger will warrant in the transaction documents to hold 5 percent of the CLO-eligible tranche for the duration of the loan. Any costs the CLO manager incurs from the forced sale of the loan could be part of their claim against the loan arranger for breach of contract. Moreover, failure of a lead arranger to keep this commitment could harm their reputation with respect to continued participation in the leveraged loan market because potential CLO managers would be less willing to engage in their transactions, leaving the lead arranger unable to sell or face higher costs in selling CLO-eligible loan tranches or any other loans, in the future.

To accommodate potential demand for CLO-eligible tranches and the concomitant costs of the ongoing credit exposure from the risk retention requirement, lead arrangers may be willing to charge higher rates to borrowers and, as a result, continue generating revenue from underwriting, warehousing, and selling leveraged loans. There is strong incentive for loan arrangers to do so given that CLO purchases of leveraged loans currently represent about half of the total investment in the leveraged loan market.[456] The prospect of CLO managers declining to purchase non CLO-eligible loan tranches should encourage lead arrangers to hold enough exposure to create CLO-eligible tranches in order to meet current investor demand. Hence, the Commission believes that CLO managers have significant influence over, and lead arrangers will have increased incentive to facilitate, the use of the lead arranger option and the creation of CLO-eligible tranches. Moreover, if non-CLO investors perceive loans with CLO-eligible tranches as higher quality loans, this may create additional demand for CLO-eligible tranches that would lead to higher prices and lower interest rates for such loans.

The Commission acknowledges the concerns about the workability of the option expressed in the comment letters and, as described above, has considered the attendant costs, but continues to believe that adopting the lead arranger option in the final rule will provide CLOs with additional meaningful flexibility in satisfying the risk retention requirements.

If the lead arranger option is not used, then CLO managers will have to satisfy the risk retention requirement using one of the standard options. In this case, the Commission recognizes that the final rule may have differing impacts on CLO managers, which could have a negative effect on competition. The amount of capital available to managers can vary with the size and affiliations of the manager. In particular, the availability and cost of capital for managers with a relatively smaller amount of capital available to finance required risk retention may be less favorable than for managers with access to larger balance sheets or sources of capital. This could result in different funding costs between smaller and larger managers and could impact competition by creating an advantage for managers with lower funding costs, particularly larger financial institutions and banks.

If smaller CLO managers do not have sufficient available capital to hold 5 percent risk retention, then they will be unable to sponsor CLO transactions unless they are able to get funding from another source. A reduction in CLO managers may reduce the number of CLOs, which may lead to a decrease in capital formation, a decrease in price efficiency for leveraged loans, and a decrease in competition for leveraged loans. If this impairs the supply of capital to borrowers using leveraged loans, such borrowers could expect to pay higher rates or have less access to financing. This potential impact on capital formation is ameliorated to the extent that larger CLO managers—or other potential investors—are able to replace smaller CLO managers as buyers of leveraged loans. Such an outcome would benefit these other investors at the expense of smaller CLO managers.

A number of commenters asserted that the final rule would force many smaller CLO managers to exit the CLO market. Because the Commission did not have data with respect to the cost of funds for each CLO manager or each CLO manager's desired return on capital, the Commission was unable to directly analyze the potential cost of the additional capital necessary to satisfy the risk retention requirements or the relative portion of the current CLO market managed by those smaller CLO managers that would no longer sponsor CLOs as a result of the increased costs. In order to estimate the potential impact of the exit of smaller CLO managers from the market, the Commission identified and categorized 111 CLO managers known to have participated in the CLO market between 2009 and 2013

[456] *See* commentaries by Wells Capital Management, ''Global Opportunities in Bank Loans'', February 2014, available at *http://www.wellscap.com/docs/expert_commentary/global_bank_loans_0214.pdf* and by Loomis, Sayles & Company, L.P. Investment, ''The Myth of Overcrowding in the Bank Loan Market'', May 2014, available at *http://www.loomissayles.com/internet/internetdata.nsf/0/CA96B70BA0BE8BB585257CD8004F1A03/$FILE/The-Myth-of-Overcrowding-in-the-Bank-Loan-Market.pdf* for the leveraged loan investor base breakdown. Statistics from both of these sources are based on data from Standard & Poor's Capital IQ Leveraged Commentary & Data.

using categorizations that serve as a proxy for the CLO managers' access to capital, whether internal or external, and thus their potential capital capacity and ability to satisfy the risk retention requirements.[457] The first category included CLO managers that are not subject to the periodic reporting requirements of the Exchange Act and do not appear to be subsidiaries of or affiliated with other financial institutions (banks, insurance companies, diversified asset managers that managed investment vehicles other than CLOs, etc.), which the Commission believes is the set of CLO managers that may face the greatest burden in obtaining capital to finance and retain the 5 percent required risk retention. These CLO managers were responsible for 39 percent of the CLO market issuances between 2009 and 2013, 37 percent by dollar volume, and represented 48 percent of all CLO managers analyzed.

The second category included CLO managers who fall into at least one of the following categories (A) subject to the periodic reporting requirements of the Exchange Act,[458] or (B) also the sponsor of asset-backed securities other than CLOs, or (C) a bank or insurance company, or (D) affiliated with, or otherwise related to an entity described in (A), (B) or (C). These CLO managers were responsible for 61 percent of CLO issuances between 2009 and 2013 by number or 63 percent of CLO issuance by dollar volume, and represented 52 percent of the population of CLO managers analyzed. The Commission believes that the second category of CLO managers, given their affiliations, diversified business lines and demonstrated ability to raise capital in public capital markets, would have greater access to capital, whether internal or external, and would face fewer obstacles and lower funding costs to obtain the capital necessary to satisfy the risk retention requirements.

If the risk retention requirements cause certain CLO managers to exit the leveraged loan market, there could be a commensurate decrease in the supply of capital unless other investors compensate for their exit. From the above analysis, the Commission believes it would be reasonable to estimate that the exit of the first category of CLO managers from the CLO market could impact current levels of capital formation by CLOs by 37 percent, which is considerably less than Oliver Wyman lower bound estimate of 60 percent.[459] The Commission believes that a significantly greater impact would be unlikely without an exit from the market of entities with potentially easier access to capital.

The potential impact of the loss of certain CLO managers will depend on whether the CLO investors would continue to supply credit to the leveraged loan market through alternative channels. If some senior CLO tranches become unavailable, then, because of their sensitivity to credit risk, banks and other investors whose investment guidelines require purchasing of very high quality loans (*e.g.,* triple-A rated) and who buy senior CLO tranches may be less likely to provide direct investment into leveraged loan market, which offers higher risk (*e.g.,* single-B rated) investments on average. In contrast, CLO investors who seek higher returns and tend to be less sensitive to credit risk may decide to participate directly in the leveraged loan market or use other intermediaries to do so because they have an appetite for that level of credit risk. Both categories of investors may channel their investments into one of multiple existing participants in the leveraged loan market. Mutual funds, private equity funds, private equity mezzanine loan funds and credit funds (entities that are generally formed as partnerships with third-party capital and invest in loans or make loans or otherwise extend the type of credit that banks are authorized to undertake on their own balance sheet) currently invest directly in the leveraged loan market and may increase their direct purchase of leveraged loans if smaller CLO managers exit the market. Thus, there are multiple existing sources of capital that could compensate for any potential exit of some CLO managers.

Based on estimates of the CLO investor base in the Oliver Wyman study (Exhibit 4 of the study), approximately 20 percent of CLO tranches are rated ''BBB'' or lower and are held by asset managers and other investors such as hedge funds, pension funds, and structured credit funds. If certain CLO deals were no longer available, assuming that these investors in lower rated tranches would be able to find an alternative channel to invest in the leveraged loan market and the remaining 80 percent (the risk-sensitive investors that purchase higher quality tranches) would not, then the overall estimated impact of a 37 percent decline in the supply of credit from the potential exit of certain CLO managers would account for an approximately 14.8 percent reduction in supply of capital to the leveraged loan market.[460] This assumes CLO sponsors comprise approximately 50 percent of the leveraged loan market,[461] and that any resulting increase in the underlying loan rates would not encourage the emergence of other capital sources. Because risk-sensitive CLO investors have other relatively low risk means of investing in the leveraged loan market (*e.g.,* mutual funds that concentrate on leveraged loans), the Commission believes that the actual impact may be lower.

vii. Qualified Tender Option Bonds

The final rule includes two options for tender option bonds (TOBs). Both options require 100 percent liquidity protection and provide for a mechanism by which the sponsors' incentives are aligned with the investors. In the first option, the sponsor maintains horizontal risk retention unless there is a tender option termination event (TOTE), in which case the sponsor's interest converts to vertical risk retention. After a TOTE, the sponsors will receive a distribution pari passu with tender option bond holders. In a termination that is triggered by an event that is not a TOTE the sponsor will continue to hold horizontal risk retention and will receive the remaining balance after the distribution is paid to the bond holders. The second option, which is very similar to a representative sample option, allows the sponsor to sell the entire TOB but requires the sponsor to hold municipal securities from the same issuance with a face

[457] CLO market issuance data and the list of CLO managers that were analyzed are from the Asset-Backed Alert database. The Commission categorized CLO sponsors that issued CLOs in the U.S. between January 1, 2009 and December 31, 2013. In order to estimate the possible impact of the risk retention requirement we examine the fraction of the CLO market that each group comprises. A sponsor's category was determined by using the 2014 Fitch Ratings CLO Asset Manager Handbook, sponsors' Web sites and other publicly available information. If it was not immediately apparent which category best described a manager, a conservative approach was taken and such manager was included in the category of managers with limited access to capital.

[458] The second category of CLO managers would also include those CLO managers that maintain a listing of a class of securities on an exchange in a non-U.S. jurisdiction.

[459] The Oliver Wyman estimate is based on a sample of the top 30 CLO managers and the assumption that managers that could feasibly hold the 5 percent risk retention make up 25 percent of the CLO assets under management.

[460] 14.8 percent is the product of the CLO market share of the leveraged loan market, 50 percent, the CLO managers market share of those CLO managers that the Commission believe it would be reasonable to assume could exit the CLO market, 37 percent, and the fraction of risk-sensitive investors in such CLOs that would not invest through other means, 80 percent (the percentage of risk-sensitive investors assumed by the Oliver Wyman study).

[461] *See* footnote 456 for references.

value of 5 percent of the deposited municipal security.

Commenters suggested providing a full exemption for TOBs, not counting TOBs as a securitization, or allowing third-party risk retention. Commenters also requested an exemption or recognition of unfunded risk retention in the form of liquidity support. They also commented on the cost to the TOB market, however, no commenter provided data to allow us to calculate potential costs from requiring risk retention to the TOB market. Requiring TOBs to hold risk retention imposes a cost on sponsors who were not currently retaining exposure to credit risk in a form permissible under the final rule.

After considering comments, the agencies have decided to adopt the reproposal options with some changes to further accommodate market practices. The agencies were not persuaded to create a structural exemption for TOBs, as commenters requested, as this would exempt future TOB structures, with unknown incentive alignment, from risk retention. Under the final rule, the agencies are accommodating the bulk of those structures currently issuing in the market.

By accommodating current market practice, these options help reduce the cost of retaining risk but still effectively align the incentives between sponsors and investors. The first option, by accommodating TOB tax requirements, allows TOBs to hold horizontal risk retention. In the absence of this accommodation, any TOB that tried to retain risk using the standard horizontal form would be in violation of the IRS tax code, invalidating the tax exemption of the TOB structure. By allowing TOB sponsors to hold horizontal risk retention while maintaining their tax exemption the first option provides additional flexibility for TOB sponsors to retain risk in a manner that better suits their specific needs, thereby reducing compliance costs. At the same time, investor-sponsor incentive alignment is maintained because sponsors have horizontal risk retention for the duration of the TOB unless a TOTE occurs at which time the TOB is terminated and the sponsor shares any losses with the investors in a pro-rata manner.

The agencies believe that the second option described above is appropriate in this specific context (as opposed to other ABS markets where the agencies do not adopt a representative sample option) because most TOBs are made up of one municipal bond, which is the same bond held by the sponsor. Thus, there are no characteristics of underlying assets that might make the representative sample different from the underlying assets, thereby skewing incentives between the sponsor and investor different. Consequently, the second option does not pose the same complexities and costs that make the representative sample option not feasible in other contexts. As with the first option, permitting this additional flexibility will help to reduce costs for TOB sponsors without jeopardizing investors' interests. In addition, the alignment of incentives may encourage investors to invest in the TOB market, which may increase capital formation. If there are more investors, liquidity will also increase, which may lead to increased price efficiency and reduce the cost of capital within the TOB market.

As mentioned above, existing TOB transactions typically have a 100 percent liquidity guarantee, which the sponsor (or an affiliate) may be providing. Thus requiring the sponsor to retain 5 percent of the risk despite this liquidity guarantee will impose additional costs but helps to ensure that the sponsor is selecting high-quality municipal bonds and not selling off their risk to a third party. The Commission also acknowledges that because these options are based on current TOB structures it may be too costly for new structures to be created. This may impact competition by creating a barrier to entry for future novel types of TOB structures.

viii. Alternatives

In developing the forms of permissible risk retention to be included the final rule, the agencies considered a number of alternative approaches. Some of the alternatives were suggested by commenters and considered by the agencies following the previous rule proposals.

In response to the reproposal, for instance, several commenters requested that the final rule recognize other forms of, or substitutes for, risk retention such as: third party credit support, including insurance policies, guarantees, liquidity facilities, and standby letters of credit; 5 percent participation interest in each securitized asset; representations and warranties; ''contractual'' risk retention; private mortgage insurance; overcollateralization; subordination; and conditional cash flows. One commenter requested that the final rule, at a minimum, should permit such forms of unfunded risk retention for a sub-set of sponsors, such as regulated banks. Another commenter asserted that the final rule should provide more flexibility by allowing sponsors to satisfy their risk retention requirement through a combination of various means and that the rule should not mandate forms of risk retention for specific types of asset classes or specific types of transactions.

The agencies have generally declined to recognize unfunded forms of risk retention for the purposes of the final rule, except in the case of the Enterprises under the conditions specified for their guarantees. The Commission acknowledges that recognizing unfunded forms of risk retention could help to reduce the costs of compliance, since many of these features are currently used, to varying degrees, in the securitization market. However, because these forms of credit support generally are not funded at closing, they may not be available to absorb credit losses at the time such losses occur. Therefore, the Commission believes that unfunded forms of risk retention fail to provide sufficient alignment of incentives between sponsors and investors and could impose unwarranted costs on investors if recognized as an eligible form of risk retention.

Further, the agencies received several comments requesting that the final rule include a representative sample or participation interest option.[462] The agencies considered allowing for loan participations as a means of satisfying the risk retention requirements. The agencies were concerned that offering loan participations as a standard option would introduce substantial additional complexity to the rule in order to ensure that these forms of retention were implemented in a way that ensured that the holder had the same economic exposure as the holder of an ABS interest. In addition, the agencies were concerned that permitting these types of interests to be held as risk retention could raise concerns about regulatory capital arbitrage. Accordingly, the agencies decided not to add a loan participation option to the menu of risk retention options. Since, according to one commenter, the option currently is not widely used by the market, the Commission believes that there may be little economic benefit to allowing this option.

c. Allocation to the Originator

The final rule permits the originator to share the risk retained by the sponsor. Specifically, the rule permits a sponsor to reduce its required risk retention obligations in a securitization

[462] *See* Section 5.b.ii of this Economic Analysis for a discussion of comments on a representative sample option.

transaction by the portion of risk retention obligations assumed by one or more of the originators of the securitized assets as long as the originator originates at least 20 percent of the securitized assets in the underlying asset pool. The originator is required to hold its allocated share of the risk retention obligation [463] in the same manner as would have been required of the sponsor, and subject to the same restrictions on transferring, hedging, or financing the retained interest.

Comments on the allocation-to-originator proposal focused on the 20 percent threshold for allocation and the requirement that an originator to which risk retention was allocated share pro rata in all of the losses allocated to the type of interest (*i.e.,* horizontal or vertical) it holds rather than only the losses on assets that it originated. Some of the commenters asserted that the 20 percent minimum should be eliminated and that it would hurt small originators while another commenter supported the limit and asserted that it protected small originators. With respect to the required pro rata sharing by the originator, commenters stated that because securitization tranches are developed so that tranche holders share *pari passu* in losses, it would cause unnecessary complexity to limit an originator's interests to the loans that it had originated. The agencies concluded that the changes to the reproposal suggested by the commenters are not necessary or appropriate. Therefore, the agencies are adopting the option largely as reproposed with minor changes.

This option benefits sponsors by allowing them to reduce their costs of retaining risk by sharing the costs with willing originators. This is also a benefit to investors as incentives are aligned at the level closer to loan origination, which could increase investor confidence and improve capital formation. As commenters noted, the allocation to originator option may create barriers to entry for smaller originators who will not be able to afford to share in retaining risk and therefore find their portfolios less liquid or more costly for sponsors to purchase. This would negatively affect competition within the securitization market. However, as noted above, the 20 percent threshold serves to make the allocation option available only for entities whose assets form a significant portion of a pool and who, thus, ordinarily could be expected to have some bargaining power with a sponsor. This will prevent sponsors from forcing the allocation to originator on smaller originators as a condition of buying the loans they originate that can increase cost of capital for such small originators or force such originators from the market thereby reducing competition. In addition, allowing smaller originators to retain a smaller fraction of credit risk of the pool could dilute the incentives generated by the risk retention requirement to monitor the credit quality of the loans in the pool, thereby undermining the intended benefits of the rule. A benefit of the adopted approach is that larger originators will be are able to help smaller sponsors that may have a harder time retaining risk and otherwise would not participate in the asset-backed securities market. Providing more sponsors with feasible options in meeting the requirements may increase capital formation and allocative efficiency.

d. Hedging, Transfer and Financing Restrictions

Under the final rule, a sponsor and its consolidated affiliates generally would be prohibited from hedging or transferring the risk they are required to retain, except for currency and interest rate hedges and some index hedging. Additionally, the sponsor and its consolidated affiliates would be prohibited from financing the retained interest on a non-recourse basis.

While some commenters supported the proposed restrictions on hedging, others criticized the provisions as being overly restrictive, and certain commenters requested clarification as to the scope of the proposed restrictions. According to some commenters, the proposed restrictions were overly broad, raising questions about what constitutes permissible and impermissible hedges.

The agencies are adopting hedging, transfer and financing restrictions as reproposed. Without the hedging and transfer restrictions, sponsors could hedge/transfer their (credit) risk exposure to the retained interests, thereby eliminating the ''skin in the game'' intent of the rule. Thus, the restriction benefits investors by preventing actions that could undermine the purpose of the final rule. More narrowly tailored restrictions could impose costs on investors by inadvertently excluding transactions that have the effect of hedging or transferring credit risk. On the other hand, the broad nature of the adopted restrictions could create uncertainty about which transactions are covered by the prohibition. This uncertainty may induce strategic responses that are designed to evade the rule. For example, derivative or cash instrument positions can be used to hedge risk, but it may be difficult to determine whether such a hedge is designed to evade the rule.

Costs related to the hedging and transfer restrictions include direct administrative costs and compliance monitoring costs. The hedging, transfer, and financing restrictions cover sponsors and their affiliates, and, thus, to assure compliance a sponsor must track both its own portfolio and the portfolios of all its affiliates to verify that no prohibited transactions are included in the aggregate portfolio. Such tracking may present additional challenges for large financial organizations with many affiliates. However, because the hedging and transfer prohibitions cover only hedging against the risks of the specific pool or securities based on the specific pool, the ultimate cost of monitoring compliance should be minimal even for large organizations.

6. General Exemptions

In certain cases the agencies have determined to exempt asset classes from the risk retention requirements altogether or adopt reduced risk retention requirements. As discussed below, the Commission believes these exemptions are warranted because there is either sufficient incentive alignment already in place or other features to make further constraints unnecessary to address moral hazard concerns. In particular, the securitizations of these exempted asset classes have characteristics that help to ensure that the quality of the assets is high. For example, if the pool of assets are drawn from an asset class with a low probability of default, opportunities to exploit potentially misaligned incentives are fewer and investors may have a correspondingly lesser need for the protection accorded by risk retention requirements. Below the Commission describes the particular costs and benefits relevant to each of the asset classes that the agencies are exempting from risk retention.

a. Federally Insured or Guaranteed Residential, Multifamily, and Health Care Mortgage Loan Assets

Consistent with Section 15G, the agencies are adopting an exemption from the risk retention requirements for any securitization transaction that is collateralized solely by residential, multifamily, or health care facility mortgage loan assets if the assets are insured or guaranteed in whole or in part as to the payment of principal and interest by the United States or an

[463] The amount of the retention interest held by each originator that is allocated credit risk in accordance with the final rule is required to be at least 20 percent, but not in excess of the percentage of the securitized assets it originated.

agency of the United States. The agencies are also adopting an exemption from the risk retention requirements for any securitization transaction that involves the issuance of ABS if the ABS are insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States and that are collateralized solely by residential, multifamily, or health care facility mortgage loan assets, or interests in such assets.

Several commenters expressed support for the exemption for securitization transactions collateralized solely by assets (or that involve the issuance of ABS) that are insured or guaranteed as to the payment of principal and interest by the United States or its agencies. One commenter urged the agencies to extend the government-backed exemptions to ABS backed by foreign governments. Another commenter requested that the agencies clarify that GSE securitizations of multifamily loans are exempt from the risk retention requirements.

Risk retention is not currently mandated or practiced for these securitizations and, thus, this exemption will maintain consistency with current market practice. Because these securitizations are guaranteed by the United States or its agencies, and there is no default risk beyond what is otherwise priced in a U.S. Treasury security, there is no benefit to investors from sponsors retaining risk and it would otherwise create costs to sponsors where they are not necessary. However, the exemption will provide continued incentives to sponsors to use federally insured or guaranteed assets, which increases the value of the securities sold. This could have an adverse impact on the capital-raising ability of sponsors offering securitizations in the same asset classes where the underlying assets are not federally insured or guaranteed, requiring these sponsors to compete for investor capital by offering higher yields and thereby selling asset backed securities interests at lower prices. As a result, there may be less demand from sponsors and investors to securitize these (non-federally insured or guaranteed) assets under private labels, which would impede the capital formation process in public markets for originators in the same asset classes that do not qualify under these programs. This could, in turn, increase borrowing costs for underlying borrowers in these assets classes.

There would be potentially significant effects, however, from not granting this exemption. In particular, these programs provide subsidized access to credit for consumers who may not otherwise qualify for loans underwritten by private issuers, and thereby promote social benefits in the public interest. For example, FHA-insured mortgages enable many home buyers, particularly those with impaired credit or who are first time buyers, to purchase a home with a low down payment that may not otherwise be possible because they would not qualify for a privately underwritten mortgage.[464] The economic footprint of this program is large. At the end of 2013, the FHA had 7.8 million active loans with insurance in force,[465] and during that year (2013), insured 1.3 million new mortgages with the total loan value of $240 billion,[466] larger than all other federally insured loan programs combined.[467] In total, the FHA provided mortgage insurance to more than 15 percent of households that purchased houses in 2012.[468]

The exemption from the risk retention requirements for securitizations of federally insured or guaranteed loans will not provide for the incentive alignment that sponsors would otherwise have with investors in the securitization if they had an economic exposure to the performance of the securitization. We note, however, that under one large federally guaranteed program, the program run by the U.S. Department of Veterans Affairs (VA), the lender has some stake in how the borrower performs unless the lender sells the loan. The VA provides insurance in the form of a first-loss guarantee,[469] but VA lenders have residual risk after the VA's first-loss obligation is exhausted. We also note that mortgage loans guaranteed by both FHA and VA programs performed better than mortgage loans securitized through private-label RMBS. For instance, both VA-guaranteed and FHA-insured mortgages originated in 2006, at the peak of the housing boom, had a significantly lower serious delinquency rate (15 percent for VA-guaranteed loans,[470] and between 18 percent[471] and 31 percent[472] by different estimates for FHA-insured loans) than mortgages securitized through private-label RMBS transactions (58 percent).[473] Although risk retention requirements were not historically practiced in private label securitizations, and delinquency rates of securitizations with risk retention during the mortgage crisis period are therefore not available, the disparity in performance between VA- and FHA-insured loans and other loans purchased for private label securitizations suggests that the combination of underwriting practices, mortgage insurance premiums, and lenders' residual risk exposure, has a material impact on the mitigation of the moral hazard problem in the securitization process.

While the historical loan performance data indicate that FHA-insured mortgages performed better than other mortgages purchased by private label securitizations, one commenter was concerned that, with the exemption, the increase in the FHA's share of the market will be difficult to shrink to a more rational proportion of the mortgage market. While the current 15 percent market share is considerably greater than 4 to 6 percent market shares during the 2004 to 2007 period, it is consistent with the historical market shares of between 12 and 14 percent during the 1993 to 2002 period, and below the 19 percent market share recorded in 2009 and 2010.[474] Hence,

[464] The Federal Reserve Board Report to the Congress on Risk Retention, October 2010, available at *http://www.federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.html.*

[465] FHA Single Family Loan Performance Trends, January 2014, Table 3, available at *http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/hsgrroom/loanperformance.*

[466] Quarterly Report to Congress on FHA Single-Family Mutual Mortgage Insurance Fund Programs, 2014, Quarter 1, Exhibits A–1 and A–2 available at *http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/rtc/fhartcqtrly.*

[467] Other federal mortgage loan guarantee programs include programs run by the Department of Veterans Affairs, the Farm Service Agency (FSA), the Rural Housing Service (RHS), and the Department of Housing and Urban Development's Office of Public and Indian Housing (PIH). Among them, for example, U.S. Department of Veterans Affairs guaranteed 630,000 loans in 2013 and Rural Housing Service guaranteed 163,000 loans in 2013, see 2013 VBA Performance and Accountability Report available at *http://www.benefits.va.gov/reports/annual_performance_reports.asp* and USDA Rural Development Housing Obligations Fiscal Year 2013 Year-End Report available at *http://ruralhome.org/storage/documents/rd_obligations/fy2013/yearend/usdard-fy13-ye-obligations-combined.pdf.*

[468] *See* FHA Share of Home Purchase Activity, June 2012, available at *http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/fhamktsh/fhamkt.*

[469] 25 percent of the loan amount with a minimum guarantee of $36,000.

[470] *See* Table 1 in Urban Institute Commentary, July 2014, ''VA Loans Outperform FHA Loans. Why? And What Can We Learn?'' available at *http://www.urban.org/UploadedPDF/413182-VA-Loans-Outperform-FHA-Loans.pdf.*

[471] *See* the FHA Loan Performance Trends report available at *http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/hsgrroom/loanperformance.*

[472] *See* footnote 471.

[473] The serious delinquency rate for mortgages securitized through private-label RMBS is calculated by DERA staff based on MBSData dataset.

[474] *See* FHA Share of Home Purchase Activity, June 2012, available at *http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/fhamktsh/fhamkt.*

the current FHA market share does not seem out of proportion relative to certain previous periods. Instead, the trend shows a strong counter cyclical relation with the health of the private market, consistent with the benefits of a federally insured program for home mortgage that provides access to capital when private markets are unable to do so.

b. Securitizations of Assets Issued, Insured or Guaranteed by the United States or any Agency of the United States

Consistent with Section 15G, the final rule contains exemptions from risk retention for any securitization transaction if the ABS issued in the transaction were (1) collateralized solely (excluding servicing assets) by obligations issued by the United States or an agency of the United States; (2) collateralized solely (excluding servicing assets) by assets that are fully insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States (other than residential, multifamily, or health care facility mortgage loan securitizations discussed above); or (3) fully guaranteed as to the timely payment of principal and interest by the United States or any agency of the United States. Also consistent with Section 15G, the final rule contains an exemption from risk retention for ABS issued or guaranteed by any state of the United States (including a political subdivision or public instrumentality of a state).

One commenter requested that the final rule retain the full exemption for securities issued by a state (including a political subdivision or public instrumentality of a state), and for securities that meet the definition of a qualified scholarship funding bond. This commenter requested that the exemption for state-issued securities and qualified scholarship funding bonds be extended to both securities issued on a federally taxable basis and securities issued on a federal tax-exempt basis. Another commenter urged that the agencies clarify that all securities issued by housing finance agencies and other state government agencies and backed by loans financed by housing finance agencies are exempted.

Risk retention is not currently mandated or practiced for these asset classes and thus, this exemption maintains consistency with current market practice. Because investors will be sufficiently protected from loss by the government guarantee that applies to these securities, there is no benefit to investors from sponsors retaining risk, and it would otherwise create costs to sponsors where they are not necessary. However, as with the exemption for federally insured mortgages, this exemption will incentivize sponsors to use federally insured or guaranteed assets, which will have an impact on competition with other assets that are not federally insured or guaranteed.

c. Certain Student Loan Securitizations

The final rule provides a separate exemption for securitization transactions that are collateralized by student loans that were made under the Federal Family Education Loan Program (FFELP). Under the final rule, a securitization transaction that is collateralized solely by FFELP loans that are guaranteed as to 100 percent of defaulted principal and accrued interest will be exempt from the risk retention requirements. A securitization transaction that is collateralized solely by FFELP loans that are guaranteed as to at least 98 percent of defaulted principal and accrued interest will have the sponsor's risk retention requirement reduced to 2 percent. All other securitizations collateralized solely by FFELP loans will have the sponsor's risk retention requirement reduced to 3 percent. Because loans underlying FFELP student loan securitizations are federally guaranteed from 97 percent to 100 percent depending on the date of origination, and there is little to no default risk beyond what is otherwise priced in a U.S. Treasury security, there is no benefit to investors from sponsors retaining risk and it would otherwise create costs to sponsors where they are not necessary.

Several commenters suggested different ways to expand the scope of the exemption or add new categories of student loans to the exemption. Other commenters recommended that the agencies accept alternative forms of risk retention for FFELP loan securitizations. The suggested alternative forms of risk retention include a simplified representative sample method, an exemption for on-balance sheet transactions where the structure clearly demonstrates at least 5 percent risk retention, initial equity contribution, overcollateralization, and other unfunded forms of risk retention.

The agencies believe that expansion of the definitions of exempted assets would undercut the purpose of risk retention of aligning incentives of sponsors and investors because other student loans would not be guaranteed by the U.S. government and, thus, would be subject to the same moral hazard problem described above. The agencies have also generally declined to recognize unfunded forms of risk retention for the purposes of the risk retention rule and continue to believe that unfunded forms of risk retention fail to provide sufficient alignment of incentives between sponsors and investors.

The economic impact of this exemption will likely be minimal because FFELP was eliminated in 2010 and student loans were no longer issued under the program after June 2010.[475]

d. Resecuritizations

The proposed rule would have provided two exemptions for certain resecuritizations where duplicative risk retention requirements would not appear to provide any added benefit. The first of these exemptions would have applied to pass-through resecuritizations that met certain specified conditions. The second one would have applied only to resecuritizations of certain first pay classes of mortgage backed securities. Under the reproposal, sponsors of resecuritizations that were not structured to meet the terms of one of these two exemptions would have been required to meet the credit risk retention requirements with respect to the resecuritization transaction unless another exemption was available.

The agencies received a number of comments on the proposed resecuritization exemptions. The comments did not raise specific objections or concerns with either of the two proposed exemptions, but generally urged the agencies to expand the exemptions to other types of structures, including those that re-tranche credit risk. Commenters noted that applying risk retention to resecuritizations of asset-backed securities that are already in the market, especially where the underlying interests are asset-backed securities compliant with the risk retention requirement, cannot alter the incentives for the original ABS sponsor to ensure high-quality assets. Other commenters stated that the lack of a broad resecuritization exemption would negatively affect markets by making it harder for investors to re-structure and sell existing ABS. A number of commenters stated that the agencies should provide an exemption for resecuritizations of ABS that were issued prior to the effective date of the rule. Still others expressed the view that the agencies could develop an exemption that would allow credit tranching in resecuritized ABS while

[475] Health Care and Education Reconciliation Act of 2010, *Pub. L. 111–152, § 2201, 124 Stat. 1029, 1074.*

limiting the scope of such exemption, such as by excluding actively managed pools, to address the agencies' concerns with CDOs and similar structures.

The agencies are adopting these exemptions as reproposed. For transactions that meet the exemptions' requirements, the resecuritization process would neither increase nor reallocate the credit risk of the underlying asset-backed securities because, by definition, there is no tranching of the credit risk in a pass through security. Hence, the resecuritization does not alter the incentive alignment present in the original securitizations that are already compliant with the risk retention requirement. Under the final rule, sponsors of resecuritizations that do not have one of the structures described above would not be exempted from risk retention. These resecuritization transactions re-tranche the credit risk of the underlying asset-backed securities, and are subject to the same moral hazard problem that exists in the underlying securitizations, because sponsors' discretion in the choice of underlying securitizations allows for the reallocation of credit risk. Hence, these resecuritizations will be subject to risk retention requirements to the same extent as the underlying asset-backed securities (unless the underlying securities qualify for an exemption). Thus, not exempting these resecuritizations is consistent with the purposes of the rule and lessens the likelihood of unwarranted costs on investors.

Because the exemption would allow the creation of securities that may be used to aggregate asset-backed securities backed by small asset pools, the exemption for these types of resecuritization could improve access to credit at reasonable terms to consumers and businesses by allowing for the creation of an additional investment vehicle for such asset pools. This, in turn, would lead to increased liquidity of such pools and attendant decrease in cost of capital for some borrowers. However, the final rule may also have an adverse impact on capital formation and efficiency if they make certain resecuritization transactions costlier or infeasible to conduct because of two layers of credit risk retention.

e. Other Exemptions and Alternatives

The reproposal also included exemptions for utility legislative securitizations, seasoned loans, and securitization transactions that are sponsored by the FDIC acting as conservator or receiver.

The agencies received no comments on the utility legislative securitization exemption, and are adopting the exemption as reproposed. The agencies continue to believe the implicit state guarantee in place for these securitizations addresses the moral hazard problem discussed above and adding the cost of risk retention would create costs to sponsors where they are not necessary as the incentive alignment problem is already being addressed.

The agencies received a number of comments on the seasoned loan exemption. Commenters generally favored expanding the seasoned loan exemption, although they differed in how to expand the exemption. Because seasoned loans have had a sufficient period of time to prove their performance, adding the cost of risk retention would create costs to sponsors where they are not necessary as any risk associated with the underlying assets' moral hazard problem will have manifested itself.

Risk retention is not currently mandated or practiced for these asset classes, and thus, permitting these exemptions will maintain consistency with current market practice. As discussed above, because these assets classes have unique features that sufficiently protect investors from loss, there is no benefit to investors from sponsors retaining risk, and it would create costs to sponsors where they are not necessary. However, providing these exemptions will incentivize the creation of utility legislative securitizations and securitizations with seasoned loans, thus potentially lowering the cost of capital formation for these loans.

In the reproposal, the agencies provided an exemption from risk retention for securitization transactions that are sponsored by the FDIC, acting as conservator or receiver. One commenter expressly supported this exemption, noting, among other things, that it would help the FDIC maximize the value of assets in conservatorship and receivership. The agencies are adopting the FDIC securitization exemption as reproposed. There is no benefit to investors from FDIC retaining risk on its securitizations because its actions are guided by sound underwriting practices and the quality of the assets is carefully monitored in accordance with the relevant statutory authority, and absence of exemption would otherwise create costs to FDIC where they are not necessary.

In response to the reproposal, commenters also asked for exemptions for other specific asset classes such as: Corporate debt repackagings, legacy loan securitizations, securitizations of unsecured direct obligations of the sponsor, and servicer advance receivables. These asset classes have either unfunded risk retention or include loans created before the new underwriting qualifications were in place and they do not have features that mitigate the moral hazard problem. Thus, providing an exemption would impose an unwarranted cost on investors.

f. Safe Harbor for Certain Foreign-Related Securitizations

The final rule includes a safe harbor provision for certain, predominantly foreign, transactions based on the limited nature of the transactions' connections with the United States and U.S. investors. Specifically, the safe harbor excludes from the risk retention requirements transactions in which, among other limitations, no more than 10 percent of the value of the ABS interests are sold to U.S. persons and no more than 25 percent of the assets collateralizing the ABS assets are acquired from U.S. persons. The safe harbor is intended to exclude from the risk retention requirements transactions in which the effects on U.S. interests are sufficiently remote so as not to significantly impact underwriting standards and risk management practices in the United States or the interests of U.S. investors.

Commenters on the proposal generally supported the existence of a safe harbor for certain foreign securitizations. A few commenters suggested increasing the 10 percent limit on the value of ABS interests permitted to be sold to or for the account of U.S. persons. These commenters also requested that the agencies clarify that the 10 percent limit applies only at the time of initial issuance and does not include secondary market transfers. Commenters also proposed to exclude from the 10 percent limitation (A) securitization transactions with a sponsor or issuing entity that is a U.S. person in which no offers are made to U.S. persons and (B) asset-backed securities issuances that comply with Regulation S under the Securities Act.

Several commenters requested that the rule provide for coordination of the rule's risk retention requirement with foreign risk retention requirements, including by permitting a foreign sponsor to comply with home country or other applicable foreign risk retention rules. In this regard, some commenters stated that the U.S. risk retention rules may be incompatible with foreign risk retention requirements, such as the European Union risk retention

requirements and, accordingly, that sponsors required to comply with both U.S. and foreign risk retention regulations could be subject to conflicting rules.

As noted in the reproposal the costs of the foreign transaction safe harbor should be small. There will be negligible effect of the safe harbor on efficiency, competition and capital formation in the United States (compared to the universal application of the risk retention rule) because the affected ABS are predominantly foreign with limited connection to U.S. markets. As noted above, the foreign transaction safe harbor is narrowly tailored to capture only those transactions in which the effects on U.S. interests are sufficiently remote so as not to significantly impact U.S. underwriting standards and risk management practices or the interests of U.S. investors. The agencies asked for comment on whether or not the 10 percent proceeds trigger should be different. Commenters suggested the proceeds trigger be raised to 20 percent or 40 percent. The agencies are adopting the foreign safe harbor provision as reproposed. The relatively narrow scope of the foreign safe harbor provision may have negative effect on foreign sponsors that seek U.S. investors because they may need to satisfy risk retention requirements of two jurisdictions (their home country and the United States). In addition, the rule may reduce competition and investment opportunities for U.S. investors because foreign securitizers may exclude U.S. persons from their transactions to avoid triggering the risk retention requirements. These costs may be mitigated by the fact that the final rule provides flexibility for sponsors with respect to the forms of eligible risk retention, which may permit foreign sponsors seeking a material U.S. investor base to retain risk in a format that satisfies both home country and U.S. regulatory requirements, without jeopardizing protection to the U.S. investors in the form of risk retention. Moreover, raising the trigger could provide sponsors relying on the safe harbor with a competitive advantage of not needing to hold risk retention. The larger the amount of the securitization foreign sponsors are allowed to sell to U.S. persons without triggering risk retention, the more competition domestic securitization deals will have to face.

7. Reduced Risk Retention Requirements for ABS Backed by Qualifying Assets

As contemplated by Section 15G, the agencies are adopting exemptions for securitizations consisting solely of automobile loans, commercial real estate loans, commercial loans, and residential mortgage loans that satisfy certain specific underwriting standards that indicate a low credit risk with respect to the loan.[476]

The benefit to exempting qualifying assets from risk retention is that it will avoid tying up sponsors' capital in transactions in which the underlying assets are subject to underwriting standards that indicate a low credit risk and thus a diminished need for risk retention to address the moral hazard problem. Avoiding this unnecessary restraint will leave sponsors with more capital available to deploy for other and potentially more efficient purposes. The economic consequences of exempting qualifying assets are analogous to the discussion associated with requiring stricter lending standards for a ''qualified mortgage'' (QM) in the residential lending market. Also there will be fewer administrative, monitoring and compliance costs for sponsors of qualifying assets if there is no risk retention. Lower costs of securitizing loans may enhance competition in the market for qualifying auto, commercial real estate and commercial loans by allowing more firms to be profitable. While we believe that the qualified standards will result in only a small percentage of securitizations to be exempt from risk retention, we believe that many of these asset classes have existing practices that are consistent with the risk retention requirements that the agencies are adopting today.[477] Further, as discussed elsewhere in this economic analysis, the agencies have made adjustments to other areas of the rule (*e.g.,* CMBS option, horizontal risk retention) to address concerns about the implementation of risk retention to particular asset classes or structures.

a. Blended Pools of Qualifying Assets

The reproposal would permit sponsors to blend pools of qualifying automobile loans, qualifying commercial loans or QCRE loans with non-qualifying assets of the same class to receive up to a 50 percent reduction in the minimum required risk retention amount.

While many sponsor commenters supported the ability to blend pools of qualifying and non-qualifying assets to obtain a reduced risk retention amount, these commenters requested that the agencies remove the 50 percent limit on the reduction for blended pools of commercial, CRE, or automobile loans. Investor commenters, however, generally opposed allowing blended pools of qualifying and non-qualifying assets.

The agencies are adopting the provision as reproposed. Allowing blended pools with a reduced risk retention requirement will improve efficiency, competition and capital formation by allowing sponsors to securitize more loans when it is difficult to obtain a large enough pool of qualifying assets to issue an ABS consisting entirely of exempted assets.

By allowing reduced risk retention on blended pools, sponsors hold less risk retention on lower quality loans than they would otherwise. For example, a sponsor that holds vertical risk retention and that forms of pool of 50 percent non-qualifying loans would be exposed to 2.5 percent of the credit risk of the non-qualifying loans compared to 5 percent if the pool were comprised entirely of non-qualifying loans. Hence, increasing the fraction of qualifying loans into the pool lessens the fraction of credit exposure to the remaining non-qualifying loans. In the extreme, inclusion of 1 percent of non-qualifying loans would result in a sponsor being exposed to only 0.05 percent of the non-qualifying loans. This could erode the disincentives of the originate-to-distribute model that the risk retention requirement was designed to address. In order to ensure sponsors hold a meaningful amount of risk and do not have incentives to underwrite and securitize low quality loans the limit on the reduction of risk retention requirement is 50 percent. Thus, even in the case of a pool of 1 percent non-qualified loans a sponsor would still have to retain 2.5 percent of the credit risk of the pool.

b. Buyback Requirement

Exempting certain type of loans gives sponsors an incentive to misrepresent qualifications of loans, similar to what was observed in the run-up to the financial crisis. However, the final rule requires that, if after issuance of a qualifying asset securitization, it was discovered that a loan did not meet the

[476] Section 15G allocates authority to prescribe the underwriting criteria for qualifying assets to the federal banking agencies, and the SEC is not promulgating this aspect of the final rule. Consequently, the Commission's Economic Analysis does not address this aspect of the final rule. However, see the discussion below for a general discussion of the economic effects of providing an exemption for qualifying assets, as contemplated by Section 15G.

[477] But see discussion of open market CLOs in Section 5.b.vi of this Economic Analysis.

qualifying underwriting criteria, the sponsor would have to repurchase or cure the loan (buyback requirement).

Commenters did not provide any comments on the buyback requirement except for the effect of the provision on CLOs. Some sponsor commenters opposed the buyback provision for CLOs, noting that open market CLO managers are thinly capitalized and generally would not have significant financial resources available to buy back loans in the pools they manage. The agencies are adopting this provision as reproposed.

The benefit of this provision is that it helps to prevent and disincentivize sponsors from trying to include non-qualifying loans in the securitization without representing them as such for the purpose of avoiding risk retention. The buyback provision should increase investors' willingness to invest because it makes sponsors of asset-backed securities responsible for correcting discovered underwriting mistakes and ensures that the actual characteristics of the underlying asset pool conform to the promised characteristics.

c. Qualified Residential Mortgages

The risk to financial markets from poor underwriting practices and inadequate disclosure of risks to investors in the RMBS securitizations is considerable. A body of academic literature has emerged since the financial crisis that supports the view that, during the early to mid-2000s, residential mortgage-backed securitizations (RMBSs) contributed to a significant decline in underwriting standards for residential mortgage loans, particularly in the private label securitization market.[478] During this time, the volume of private label RMBS issuance increased significantly from $343 billion in 2003 to $726 billion in 2005 and $685 billion by 2006.[479] GSE sponsored securitizations fell during this same period. An analysis of historical performance among loans securitized into private-label RMBS that originated between 1997 and 2009 shows that those meeting the QM standard sustained exceedingly high serious delinquency rates, greater than 30 percent during that period.[480]

These high delinquency rates underscore the moral hazard problem described earlier that can arise when disclosures to investors do not provide sufficient detail to adequately evaluate the quality of the loans backing the security. This problem was exacerbated by the fact that the underlying RMBS loan pools were typically comprised of thousands of loans that required time and resources to evaluate, but with key features of the loans not always available to investors in sufficient detail to make those evaluations. The resulting information asymmetry, combined with the originate-to-distribute incentives that allowed sponsors to receive full compensation before investors had the opportunity to learn about loan quality and ultimate risks, generated the conditions that contributed to the financial crisis. It is these conditions that the risk retention rule is designed to address.

The rule the agencies are adopting today exempts from the risk retention requirements any securitization comprised exclusively of QRMs. Section 15G requires that asset-backed securities that are collateralized solely by QRMs be completely exempted from risk retention requirements and allows the agencies to define the terms and conditions under which a residential mortgage would qualify as a QRM. Section 15G mandates that the definition of a QRM be no broader than the definition of a QM, as such term is defined under Section 129C(b)(2) of the Truth in Lending Act.

Pursuant to the statutory mandate, the agencies are exempting securitizations collateralized solely by QRMs and, pursuant to the discretion permitted, are defining QRMs as QMs. As outlined in the reproposal, the Commission believes that this definition of QRM would achieve a number of important benefits. First, since the criteria established by the Consumer Financial Protection Bureau (CFPB) to define QMs focus on underwriting standards, less risky product features, and affordability, the Commission believes that aligning the definition of QRM with QM is likely to promote more prudent lending and contribute to a sustainable, resilient and liquid mortgage securitization market.

Second, the Commission believes that a single mortgage quality standard (as opposed to creating a second mortgage quality standard) would benefit market participants by simplifying the lending and securitization requirements and eligibilities applicable to the residential mortgage and RMBS market. Moreover, having a separate mortgage standard for the exemption from risk retention could impact the relevance of the QM standard, particularly if the definitions were not sufficiently different. For example, if the two standards resulted in qualified mortgages of similar risk, it is possible that sponsors would focus on securitizing only mortgages that met the higher QRM standard because of the exemption from risk retention. If so, this could impact access to capital for creditworthy borrowers who could not secure a QRM, because their loans would be less attractive to securitizers and impact an originator's ability to sell it. Commenters suggested that this would hit middle income and first time borrowers the hardest, and have a detrimental impact to capital formation.

Third, a broad definition of QRM avoids the potential effect of squeezing out certain lenders, such as community banks and credit unions, which may not have sufficient resources to hold the capital associated with the origination of non-QRMs, thus enhancing competition within this segment of the lending market. The Commission believes that a broad QRM definition will increase the ability of these lenders to securitize their mortgage originations and thus increase their ability to generate new loans and facilitate enhanced borrower access to capital.

Finally, a broad definition of QRM may help encourage the re-emergence of private capital in securitization markets. The Enterprises currently have a competitive advantage over private label securitizations because the Enterprises benefit from lower funding costs attributed to the recognition of their explicit Federal capital support, a subsidy to their lending activity that is not available to private label securitizations. Moreover, the Enterprises' current guarantee of their securitizations fulfill the risk retention requirements as long as they are in receivership and conservatorship and meet other conditions, and they would not have the same concomitant costs of complying with the rule as private parties during this time. Hence, the less restrictive QRM criteria should enhance the competitiveness of sponsors of private label securitizations by expanding the scope of loans eligible for securitization without triggering risk retention requirements. This, in turn, would reduce the need for borrowers to rely on programs offered by the Enterprises.

Aligning the definition of QRM to QM incorporates into the definition of QRM certain loan product features that historical performance data indicates

[478] Keys, Mukherjee, Seru and Vig, ''Did Securitization Lead to Lax Screening? Evidence from Subprime Loans'', Quarterly Journal of Economics, vol. 125, no. 1, pp. 307–362, February 2010 and Nadauld and Sherlund, ''The Impact of Securitization on the Expansion of Subprime Credit'', Journal of Financial Economics, vol. 107, no. 2, February 2013, pp. 454–476.

[479] Source: SIFMA Statistics available at *http://www.sifma.org/research/statistics.aspx.*

[480] *See* Joshua White and Scott Bauguess, *Qualified Residential Mortgage: Background Data Analysis on Credit Risk Retention,* (August 2013), *available at http://www.sec.gov/divisions/riskfin/whitepapers/qrm-analysis-08-2013.pdf.*

results in a lower risk of default. The Commission thus acknowledges that the QM standard does not fully address the loan underwriting features that are most likely to result in a lower risk of default, including down payment requirements and measures of borrower credit history. The Commission, however, believes that other regulatory developments may provide investors with additional information that allows them to more effectively assess the potential risks underlying securitizations as well as more effective recourse against sponsors when problems arise with the performance of underlying loans. In particular, the Commission has recently adopted revisions to Regulation AB [481] that require in registered RMBS transactions disclosure of detailed loan-level information at the time of issuance and on an ongoing basis. As previously described, for registered offerings covered by the revised Regulation AB, the loan level disclosures should enhance an investor's ability to accurately assess the quality of the underlying assets. The revised Regulation AB also requires issuers to provide investors with this information in sufficient time prior to the first sale of securities so that they can analyze this information when making their investment decision and provides additional transactional safeguards for registered shelf offerings. These regulatory reforms, combined with the prudential underwriting standards embodied in the QM definition, should serve to significantly mitigate the moral hazard problem for registered RMBS securitizations. As previously discussed, private-label securitizations issued through unregistered offerings are not subject to the asset-level requirements under revised Regulation AB.

The Commission is aware that defining QRMs broadly to equate with the definition of QM may result in a number of economic costs. Most notably, sponsors will not be required to retain an economic interest in the credit risk of QRM loans, and thus, there will be less incentivized to avoid the originate-to-distribute model that can contribute to poor quality underwriting and the obfuscation of risk to the ultimate investors in RMBS securitizations. Moreover, although the QRM exemption is based on the premise that well-underwritten mortgages were not the cause of the financial crisis, the criteria for QM loans do not account for all borrower characteristics that may provide additional information about default rates. In particular, QM loans do not account for certain underwriting and product features that historical loan performance indicate lower risk of default. For instance, borrowers' credit history, down payment and loan-to-value ratio have been shown to be significantly associated with lower borrower default rates.[482] This introduces additional risk into securitizations without a risk retention requirement relative to a more narrowly defined QRM definition.

Some commenters indicated that the QM-Plus alternative proposal that included a down payment requirement was unnecessarily restrictive, did not account for compensating factors in underwriting practices, and that the foreclosure crisis was predominantly a result of abusive loan terms and practices that are addressed by the QM definition. The commenters concluded that the QM definition adequately addresses product features that historical loan performance data indicate result in a lower risk of default, that low down payment loans have been used with great success to promote sustainable homeownership, and aligning the definition of QRM to QM strikes the right balance of improved standards and the need to improve access to affordable credit on reasonable terms.

Commenters also questioned the estimated delinquency rates reported in the Commission analysis of historical loan performance among loans packaged by private label securitizations that would have met the current QM definition. These commenters claimed that the SEC staff study included loans with risky features linked to default that would not meet the QM definition, and that the period of analysis of the SEC staff study focused too narrowly on the origination years leading up to the financial crisis, and thus the most poorly underwritten mortgages. As a result, these commenters stated that the 34 percent estimated serious delinquency rate among securitized private label loans found in the SEC staff study did not fairly reflect the effect of the QM definition, which when applied to their broader sample of mortgages (that included GSE purchased loans and non-securitized loans) was 5.8 percent.

The Commission recognizes that estimates of delinquency rates are sensitive to the sample of mortgages analyzed, and in particular, can vary significantly based on the time period and types of loans analyzed. In particular, as previously noted, there is a large difference in the historical performance of GSE purchased loans, for which GSEs' current guarantee fulfills the risk retention requirements as long as GSEs are in receivership and conservatorship and meet other conditions, which effectively currently exempts such loans from risk retention requirements, and securitized private labels loans. The SEC staff study focused on securitized private labels loans to respond to previous commenter concern that the original proposal inappropriately focused on loans purchased by GSEs and thus excluded originations held in non-GSE securitizations. The SEC staff study also focused on the years leading up to the crisis years because this was the period of underwriting abuses for which the presence of a QM definition would have had the most relevance. Moreover, the 34 percent delinquency rate reported in the SEC staff study is consistent with estimates provided in the analysis of another commenter when restricted to the same loan types and period.[483]

As previously discussed, some asymmetric information issues contributing to the moral hazard problem of the originate-to-distribute model are addressed by the revisions to Regulation AB. In particular, while registered RMBS backed by QRM loans are exempt from risk retention, issuers of such securities are required to provide loan-level information for each asset in the underlying pool in accordance with revised Regulation AB. Thus, the moral hazard problem is reduced for these issuances because asset-level disclosure should mitigate the information asymmetry problem to the extent that the disclosures adequately inform investors of the risks.

At present, private label RMBS transactions comprise only a small fraction of the total non-agency asset-backed securities market—6.4 percent by dollar volume in 2013.[484] Moreover, only 16 percent of RMBS were registered issues. This is far below the pre-crisis levels. For example, the issuance volume of private label RMBS securitizations was $801 billion in 2006, which accounted for 39 percent of the total non-agency asset-backed securities issuance in 2006. Of these transactions, only 9.3 percent were privately-issued offerings (*e.g.,* resales under Rule 144A or private placements), transactions that would not be subject to asset-level disclosures by the revised Regulation AB rules. If the private label

[481] See 79 FR 57184.

[482] *See* footnote 481.

[483] Urban Institute, Table 1 reports 36 percent delinquency rate for Private Label Securities originated during the 2006–2008 period.

[484] All figures in this paragraph are calculated by DERA staff using the Asset-Backed Alert and Commercial Mortgage Alert databases.

securitization market were to return to pre-crisis levels and registration practices, then a significant portion of the RMBS market would be subject to asset-level disclosures. For the remaining unregistered offerings, risk retention requirements would still apply and address the potential moral hazard problem to the extent that the underlying securitizations were not comprised of QRMs.

Broadly, by aligning the definition of QRM to QM the agencies are fostering the least restrictive capital formation regime for residential mortgages allowed under the statute. This alignment allows for securitizations exempt from the requirement of risk retention that include loans with low down payment and loans without down payment or borrower credit history requirements. By not adopting these additional credit overlays, the agencies have sought to facilitate the ability of mortgage originators to have sponsors package their loans into securitizations and thereby generate new capital for the continued origination of new mortgages. In the near term, under prevailing tight mortgage lending conditions, this definition is intended to promote borrower access to capital, especially for low-and moderate income, minority and first-time home buyers, and accelerate the recovery of the private label RMBS market.

However, aligning the definition of QRM to QM also provides the least restrictive regulatory measure available under the statute to mitigate the reemergence of the moral hazard problem in the RMBS market. By exempting from the risk retention requirement securitizations comprised of loans with characteristics that historically have been indicators of a higher probability of mortgage default, the same economic incentives for the originate-to-distribute model that existed prior to the onset of the financial crisis may persist.

Hence the alignment of the definition of the two mortgage standards involves a tradeoff between, on the one hand, promoting financial market recovery and borrower access to capital, and, on the other hand, adding additional credit requirements that may lessen the likelihood of future moral hazards related to the lending practices in the housing market but also further constrain mortgage credit. The agencies have sought to address this tradeoff through the introduction of a periodic review of the QRM definition that allows the agencies to monitor the rule's effects as the RMBS market evolves in the new regulatory environment. The agencies will review the QRM definition at regular intervals and in response to any changes made to the QM definition by the CFPB, and as a result of these reviews, may or may not decide to modify the definition of QRM through notice and comment rulemaking. Moreover, the agencies will commence a review at any time upon the request of any one of the agencies. By including this review process in the final rule, the agencies recognize that prevailing market conditions could change in a way that merits a stricter definition of QRM, and have introduced a process by which the alignment of QRM to QM can be assessed going forward.

d. Mortgage Loans Exempt From QM

The agencies are also adopting an exemption from risk retention for securitizations of loans originated through community-focused lending programs that are currently exempt from the CFPB's ability-to-repay requirements and an exemption for certain three-to-four unit mortgage loans.

Exempting securitizations of loans originated through community-focused lending programs that are currently exempt from the CFPB's ability-to-repay requirements from risk retention will increase capital formation. The mission of many of these community-based lenders is to provide access to capital for underserved communities; requiring risk retention for them would impose a cost that might impinge on their ability to make loans or might increase their cost of capital. The borrowers that rely on community based lenders may also avoid higher borrowing costs as the result of this exemption. Efficiency may be improved to the extent community based underwriters have more information about their borrowers than other lenders and use soft information to underwrite their loans.[485] We acknowledge, however, that underwriting standards may change allowing lower quality loans to be securitized. The exemption for these loans, as with QRM, however, will be subject to periodic review by the agencies.

The agencies are also providing an exemption from the risk retention requirements for certain mortgage loans secured by three-to-four unit residential properties that meet the criteria for QM other than being a consumer credit transaction, as well as an exemption to permit sponsors to securitize these exempted mortgage loans with QRMs. The exemption for these loans, as with QRM, will be subject to periodic review by the agencies.

Even though three-to-four unit mortgages comprise a relatively small fraction of the one-to-four residential mortgage market, exempting securitizations of such loans from risk retention could increase access to capital for these borrowers. Among loans acquired or guaranteed by Fannie Mae (Freddie Mac) between 2000 and 2013, only 0.93 percent (0.70 percent) of loans by initial balance were three-to-four unit mortgages, and the total principal balance of such mortgages acquired or guaranteed by the Enterprises exceeded $56 billion. Three-to-four unit mortgages were slightly more prominent in the private-label securitization market, for which 1.51 percent of loans by initial balance were three-to-four unit mortgages, with the total original principal balance of almost $23 billion.[486]

Currently, the Enterprises' guarantee is an acceptable form of risk retention as long as they are in receivership or conservatorship and meet other conditions. Thus, under current conditions, three-to-four unit mortgages guaranteed by the Enterprises can be securitized without having to comply with the risk retention requirements. However, without the exemption, should the Enterprises in the future no longer be in receivership or conservatorship, these three-to-four unit mortgages would be subject to the risk retention requirements even if they otherwise met the QM criteria. The exemption will allow such mortgages to continue to be securitized with two unit mortgages, as has been historical practice, regardless of the legal status of the Enterprises and provided that all of the loans in the pool meet the QM criteria. In this way, the exemption will help to facilitate continued access to capital for borrowers of three-to-four unit mortgages.

Based on historical data, three-to-four unit residential mortgages that otherwise satisfy the QM criteria exhibit comparable or lower delinquency rates as QM two unit residential mortgages. The average serious delinquency rate[487]

[485] *See, e.g.,* O.E. Ergungor, ''Bank Branch Presence and Access to Credit in Low- to Moderate-Income Neighborhoods'' Journal of Money, Credit, and Banking, 2010; S. Agrawal, B. Ambrose, S. Chomsisengphet, and C. Liu, ''The role of Soft Information in a Dynamic Contract Setting: Evidence from the Home Equity Credit Market,'' Journal of Money Credit and Banking, 2011; C. Chang, G. Liao, Z. Yu, Z. Ni, ''Information From Relationship Lending: Evidence from Loan Defaults in China,'' working paper, 2010.

[486] DERA staff calculations based on MBSData dataset. The dataset provides data for the number of units for 31.3 percent of the loans securitized privately between 2000 and 2012.

[487] Serious delinquency (SDQ) is defined as a loan having ever been 90 days late, foreclosed, or real estate owned.

among such three-to-four unit mortgages securitized through private-label securitizations in 2000–2009 was 36 percent, whereas among two unit mortgages it was 41 percent. Moreover, the difference in delinquency rates are not statistically different when controlling for other factors known to influence delinquency rates like credit score, loan-to-value ratio, debt-to-income ratio, etc.[488] These results indicate that historical three-to-four unit residential mortgage delinquency rates are no higher than those of two unit residential mortgages, and thus do not provide any evidence that exempting such mortgages from risk retention would introduce additional risk into securitizations that would include such loans. The Commission believes that this equivalent performance is likely to continue after the implementation of this exemption because both two unit and three-to-four unit mortgages would be required to satisfy the same QM underwriting criteria.

D. OCC Unfunded Mandates Reform Act of 1995 Determination

Section 202 of the Unfunded Mandates Reform Act of 1995, Public Law 104–4 (UMRA) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in an expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of $100 million or more, adjusted for inflation ($152 million in 2014) in any one year. If a budgetary impact statement is required, section 205 of the UMRA also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule.

The OCC has determined this final rule is likely to result in the expenditure by the private sector of $152 million or more in any one year. The OCC has prepared a budgetary impact analysis and identified and considered alternative approaches, including approaches suggested by commenters and discussed in the **SUPPLEMENTARY INFORMATION** section above. When the final rule is published in the **Federal Register**, the full text of the OCC's analysis will be available at: *http://www.regulations.gov*, Docket ID OCC–2013–0010.

E. FHFA: Considerations of Differences Between the Federal Home Loan Banks and the Enterprises

Section 1313 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 requires the Director of FHFA, when promulgating regulations relating to the Federal Home Loan Banks (Banks), to consider the following differences between the Banks and the Enterprises (Fannie Mae and Freddie Mac): cooperative ownership structure; mission of providing liquidity to members; affordable housing and community development mission; capital structure; and joint and several liability.[489] The Director also may consider any other differences that are deemed appropriate. In preparing the portions of this final rule over which FHFA has joint rulemaking authority, the Director considered the differences between the Banks and the Enterprises as they relate to the above factors and determined that the rule was appropriate. No comments were received on the reproposed rule with respect to this issue.

Text of the Common Rule

(All Agencies)

The text of the common rule appears below:

PART__—CREDIT RISK RETENTION

Subpart A—Authority, Purpose, Scope and Definitions

Sec.

__.1 [Reserved]
__.2 Definitions.

Subpart B—Credit Risk Retention

__.3 Base risk retention requirement.
__.4 Standard risk retention.
__.5 Revolving pool securitizations.
__.6 Eligible ABCP conduits.
__.7 Commercial mortgage-backed securities.
__.8 Federal National Mortgage Association and Federal Home Loan Mortgage Corporation ABS.
__.9 Open market CLOs.
__.10 Qualified tender option bonds.

Subpart C—Transfer of Risk Retention

__.11 Allocation of risk retention to an originator.
__.12 Hedging, transfer and financing prohibitions.

Subpart D—Exceptions and Exemptions

__.13 Exemption for qualified residential mortgages.
__.14 Definitions applicable to qualifying commercial loans, commercial real estate loans, and automobile loans.
__.15 Qualifying commercial loans, commercial real estate loans, and automobile loans.
__.16 Underwriting standards for qualifying commercial loans.
__.17 Underwriting standards for qualifying CRE loans.
__.18 Underwriting standards for qualifying automobile loans.
__.19 General exemptions.
__.20 Safe harbor for certain foreign-related transactions.
__.21 Additional exemptions.
__.22 Periodic review of the QRM definition, exempted three-to-four unit residential mortgage loans, and community-focused residential mortgage exemption.

Subpart A—Authority, Purpose, Scope and Definitions

§__.1 [Reserved]

§__.2 Definitions.

For purposes of this part, the following definitions apply:

ABS interest means:

(1) Any type of interest or obligation issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest or residual interest (other than an uncertificated regular interest in a REMIC that is held by another REMIC, where both REMICs are part of the same structure and a single REMIC in that structure issues ABS interests to investors, or a non-economic residual interest issued by a REMIC), payments on which are primarily dependent on the cash flows of the collateral owned or held by the issuing entity; and

(2) Does not include common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests that:

(i) Are issued primarily to evidence ownership of the issuing entity; and

(ii) The payments, if any, on which are not primarily dependent on the cash flows of the collateral held by the issuing entity; and

(3) Does not include the right to receive payments for services provided by the holder of such right, including servicing, trustee services and custodial services.

Affiliate of, or a person *affiliated* with, a specified person means a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

Appropriate Federal banking agency has the same meaning as in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813).

[488] Specifically, DERA staff ran the predictive logit regression from the White and Bauguess (2013) study (see footnote 446) for privately securitized 2, 3, and 4 unit mortgages in the MBSData database satisfying QM criteria and originated over the period 2000–2009. Adding an indicator variable marking three-to-four unit residential mortgages does not generate a statistically significant coefficient estimate, and does not improve the regression's goodness-of-fit measure (pseudo-R-squared).

[489] *See* 12 U.S.C. 4513.

Asset means a self-liquidating financial asset (including but not limited to a loan, lease, mortgage, or receivable).

Asset-backed security has the same meaning as in section 3(a)(79) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(79)).

Collateral means, with respect to any issuance of ABS interests, the assets that provide the cash flow and the servicing assets that support such cash flow for the ABS interests irrespective of the legal structure of issuance, including security interests in assets or other property of the issuing entity, fractional undivided property interests in the assets or other property of the issuing entity, or any other property interest in or rights to cash flow from such assets and related servicing assets. Assets or other property *collateralize* an issuance of ABS interests if the assets or property serve as collateral for such issuance.

Commercial real estate loan has the same meaning as in § __.14.

Commission means the Securities and Exchange Commission.

Control including the terms ''controlling,'' ''controlled by'' and ''under common control with'':

(1) Means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

(2) Without limiting the foregoing, a person shall be considered to control another person if the first person:

(i) Owns, controls or holds with power to vote 25 percent or more of any class of voting securities of the other person; or

(ii) Controls in any manner the election of a majority of the directors, trustees or persons performing similar functions of the other person.

Credit risk means:

(1) The risk of loss that could result from the failure of the borrower in the case of a securitized asset, or the issuing entity in the case of an ABS interest in the issuing entity, to make required payments of principal or interest on the asset or ABS interest on a timely basis;

(2) The risk of loss that could result from bankruptcy, insolvency, or a similar proceeding with respect to the borrower or issuing entity, as appropriate; or

(3) The effect that significant changes in the underlying credit quality of the asset or ABS interest may have on the market value of the asset or ABS interest.

Creditor has the same meaning as in 15 U.S.C. 1602(g).

Depositor means:

(1) The person that receives or purchases and transfers or sells the securitized assets to the issuing entity;

(2) The sponsor, in the case of a securitization transaction where there is not an intermediate transfer of the assets from the sponsor to the issuing entity; or

(3) The person that receives or purchases and transfers or sells the securitized assets to the issuing entity in the case of a securitization transaction where the person transferring or selling the securitized assets directly to the issuing entity is itself a trust.

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 or allocation 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 payable to the eligible horizontal residual interest prior to any reduction in the amounts payable 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, with the exception of any non-economic REMIC residual interest, has the most subordinated claim to payments of both principal and interest by the issuing entity.

Eligible horizontal cash reserve account means an account meeting the requirements of § __.4(b).

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 proportion of each such class.

Federal banking agencies means the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation.

GAAP means generally accepted accounting principles as used in the United States.

Issuing entity means, with respect to a securitization transaction, the trust or other entity:

(1) That owns or holds the pool of assets to be securitized; and

(2) In whose name the asset-backed securities are issued.

Majority-owned affiliate of a person means an entity (other than the issuing entity) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, such person. 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.

Originator means a person who:

(1) Through an extension of credit or otherwise, creates an asset that collateralizes an asset-backed security; and

(2) Sells the asset directly or indirectly to a securitizer or issuing entity.

REMIC has the same meaning as in 26 U.S.C. 860D.

Residential mortgage means:

(1) A transaction that is a covered transaction as defined in § 1026.43(b) of Regulation Z (12 CFR 1026.43(b)(1));

(2) Any transaction that is exempt from the definition of ''covered transaction'' under § 1026.43(a) of Regulation Z (12 CFR 1026.43(a)); and

(3) Any other loan secured by a residential structure that contains one to four units, whether or not that structure is attached to real property, including an individual condominium or cooperative unit and, if used as a residence, a mobile home or trailer.

Retaining sponsor means, with respect to a securitization transaction, the sponsor that has retained or caused to be retained an economic interest in the credit risk of the securitized assets pursuant to subpart B of this part.

Securitization transaction means a transaction involving the offer and sale of asset-backed securities by an issuing entity.

Securitized asset means an asset that:

(1) Is transferred, sold, or conveyed to an issuing entity; and

(2) Collateralizes the ABS interests issued by the issuing entity.

Securitizer means, with respect to a securitization transaction, either:

(1) The depositor of the asset-backed securities (if the depositor is not the sponsor); or

(2) The sponsor of the asset-backed securities.

Servicer means any person responsible for the management or collection of the securitized assets or making allocations or distributions to holders of the ABS interests, but does not include a trustee for the issuing entity or the asset-backed securities that makes allocations or distributions to

holders of the ABS interests if the trustee receives such allocations or distributions from a servicer and the trustee does not otherwise perform the functions of a servicer.

Servicing assets means rights or other assets designed to assure the servicing or timely distribution of proceeds to ABS interest holders and rights or other assets that are related or incidental to purchasing or otherwise acquiring and holding the issuing entity's securitized assets. Servicing assets include amounts received by the issuing entity as proceeds of securitized assets, including proceeds of rights or other assets, whether as remittances by obligors or as other recoveries.

Single vertical security means, with respect to any securitization transaction, an ABS interest entitling the sponsor to a specified percentage of the amounts paid on each class of ABS interests in the issuing entity (other than such single vertical security).

Sponsor means 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.

State has the same meaning as in Section 3(a)(16) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(16)).

United States or U.S. means the United States of America, including its territories and possessions, any State of the United States, and the District of Columbia.

Wholly-owned affiliate means a person (other than an issuing entity) that, directly or indirectly, wholly controls, is wholly controlled by, or is wholly under common control with, another person. For purposes of this definition, ''wholly controls'' means ownership of 100 percent of the equity of an entity.

Subpart B—Credit Risk Retention

§ _.3 Base risk retention requirement.

(a) *Base risk retention requirement.* Except as otherwise provided in this part, the sponsor of a securitization transaction (or majority-owned affiliate of the sponsor) shall retain an economic interest in the credit risk of the securitized assets in accordance with any one of §§ _.4 through __.10. Credit risk in securitized assets required to be retained and held by any person for purposes of compliance with this part, whether a sponsor, an originator, an originator-seller, or a third-party purchaser, except as otherwise provided in this part, may be acquired and held by any of such person's majority-owned affiliates (other than an issuing entity).

(b) *Multiple sponsors.* If there is more than one sponsor of a securitization transaction, it shall be the responsibility of each sponsor to ensure that at least one of the sponsors of the securitization transaction (or at least one of their majority-owned or wholly-owned affiliates, as applicable) retains an economic interest in the credit risk of the securitized assets in accordance with any one of §§ __.4, _.5, _.8, __.9, or _.10.

§ _.4 Standard risk retention.

(a) *General requirement.* Except as provided in §§ __.5 through __.10, the sponsor of a securitization transaction must retain an eligible vertical interest or eligible horizontal residual interest, or any combination thereof, in accordance with the requirements of this section.

(1) If the sponsor retains only an eligible vertical interest as its required risk retention, the sponsor must retain an eligible vertical interest in a percentage of not less than 5 percent.

(2) If the sponsor retains only an eligible horizontal residual interest as its required risk retention, the amount of the interest must equal at least 5 percent of the fair value of all ABS interests in the issuing entity issued as a part of the securitization transaction, determined using a fair value measurement framework under GAAP.

(3) If the sponsor retains both an eligible vertical interest and an eligible horizontal residual interest as its required risk retention, the percentage of the fair value of the eligible horizontal residual interest and the percentage of the eligible vertical interest must equal at least five.

(4) The percentage of the eligible vertical interest, eligible horizontal residual interest, or combination thereof retained by the sponsor must be determined as of the closing date of the securitization transaction.

(b) *Option to hold base amount in eligible horizontal cash reserve account.* In lieu of retaining all or any part of an eligible horizontal residual interest under paragraph (a) of this section, the sponsor may, at closing of the securitization transaction, cause to be established and funded, in cash, an eligible horizontal cash reserve account in the amount equal to the fair value of such eligible horizontal residual interest or part thereof, provided that the account meets all of the following conditions:

(1) The account is held by the trustee (or person performing similar functions) in the name and for the benefit of the issuing entity;

(2) Amounts in the account are invested only in cash and cash equivalents; and

(3) Until all ABS interests in the issuing entity are paid in full, or the issuing entity is dissolved:

(i) Amounts in the account shall be released only to:

(A) Satisfy payments on ABS interests in the issuing entity on any payment date on which the issuing entity has insufficient funds from any source to satisfy an amount due on any ABS interest; or

(B) Pay critical expenses of the trust unrelated to credit risk on any payment date on which the issuing entity has insufficient funds from any source to pay such expenses and:

(*1*) Such expenses, in the absence of available funds in the eligible horizontal cash reserve account, would be paid prior to any payments to holders of ABS interests; and

(*2*) Such payments are made to parties that are not affiliated with the sponsor; and

(ii) Interest (or other earnings) on investments made in accordance with paragraph (b)(2) of this section may be released once received by the account.

(c) *Disclosures.* A sponsor relying on this section shall provide, or cause to be provided, to potential investors, under the caption ''Credit Risk Retention'', a reasonable period of time prior to the sale of the asset-backed securities in the securitization transaction the following disclosures in written form and within the time frames set forth in this paragraph (c):

(1) *Horizontal interest.* With respect to any eligible horizontal residual interest held under paragraph (a) of this section, a sponsor must disclose:

(i) A reasonable period of time prior to the sale of an asset-backed security issued in the same offering of ABS interests,

(A) The fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS interests are issued, as applicable)) of the eligible horizontal residual interest that the sponsor expects to retain at the closing of the securitization transaction. If the specific prices, sizes, or rates of interest of each tranche of the securitization are not available, the sponsor must disclose a range of fair values (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and dollar amount (or corresponding

amount in the foreign currency in which the ABS interests are issued, as applicable)) of the eligible horizontal residual interest that the sponsor expects to retain at the close of the securitization transaction based on a range of bona fide estimates or specified prices, sizes, or rates of interest of each tranche of the securitization. A sponsor disclosing a range of fair values based on a range of bona fide estimates or specified prices, sizes or rates of interest of each tranche of the securitization must also disclose the method by which it determined any range of prices, tranche sizes, or rates of interest.

(B) A description of the material terms of the eligible horizontal residual interest to be retained by the sponsor;

(C) A description of the valuation methodology used to calculate the fair values or range of fair values of all classes of ABS interests, including any portion of the eligible horizontal residual interest retained by the sponsor;

(D) All key inputs and assumptions or a comprehensive description of such key inputs and assumptions that were used in measuring the estimated total fair value or range of fair values of all classes of ABS interests, including the eligible horizontal residual interest to be retained by the sponsor.

(E) To the extent applicable to the valuation methodology used, the disclosure required in paragraph (c)(1)(i)(D) of this section shall include, but should not be limited to, quantitative information about each of the following:

(*1*) Discount rates;

(*2*) Loss given default (recovery);

(*3*) Prepayment rates;

(*4*) Default rates;

(*5*) Lag time between default and recovery; and

(*6*) The basis of forward interest rates used.

(F) The disclosure required in paragraphs (c)(1)(i)(C) and (D) of this section shall include, at a minimum, descriptions of all inputs and assumptions that either could have a material impact on the fair value calculation or would be material to a prospective investor's ability to evaluate the sponsor's fair value calculations. To the extent the disclosure required in this paragraph (c)(1) includes a description of a curve or curves, the description shall include a description of the methodology that was used to derive each curve and a description of any aspects or features of each curve that could materially impact the fair value calculation or the ability of a prospective investor to evaluate the sponsor's fair value calculation. To the extent a sponsor uses information about the securitized assets in its calculation of fair value, such information shall not be as of a date more than 60 days prior to the date of first use with investors; provided that for a subsequent issuance of ABS interests by the same issuing entity with the same sponsor for which the securitization transaction distributes amounts to investors on a quarterly or less frequent basis, such information shall not be as of a date more than 135 days prior to the date of first use with investors; provided further, that the balance or value (in accordance with the transaction documents) of the securitized assets may be increased or decreased to reflect anticipated additions or removals of assets the sponsor makes or expects to make between the cut-off date or similar date for establishing the composition of the asset pool collateralizing such asset-backed security and the closing date of the securitization.

(G) A summary description of the reference data set or other historical information used to develop the key inputs and assumptions referenced in paragraph (c)(1)(i)(D) of this section, including loss given default and default rates;

(ii) A reasonable time after the closing of the securitization transaction:

(A) The fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS are issued, as applicable)) of the eligible horizontal residual interest the sponsor retained at the closing of the securitization transaction, based on actual sale prices and finalized tranche sizes;

(B) The fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS are issued, as applicable)) of the eligible horizontal residual interest that the sponsor is required to retain under this section; and

(C) To the extent the valuation methodology or any of the key inputs and assumptions that were used in calculating the fair value or range of fair values disclosed prior to sale and required under paragraph (c)(1)(i) of this section materially differs from the methodology or key inputs and assumptions used to calculate the fair value at the time of closing, descriptions of those material differences.

(iii) If the sponsor retains risk through the funding of an eligible horizontal cash reserve account:

(A) The amount to be placed (or that is placed) by the sponsor in the eligible horizontal cash reserve account at closing, and the fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS interests are issued, as applicable)) of the eligible horizontal residual interest that the sponsor is required to fund through the eligible horizontal cash reserve account in order for such account, together with other retained interests, to satisfy the sponsor's risk retention requirement;

(B) A description of the material terms of the eligible horizontal cash reserve account; and

(C) The disclosures required in paragraphs (c)(1)(i) and (ii) of this section.

(2) *Vertical interest.* With respect to any eligible vertical interest retained under paragraph (a) of this section, the sponsor must disclose:

(i) A reasonable period of time prior to the sale of an asset-backed security issued in the same offering of ABS interests,

(A) The form of the eligible vertical interest;

(B) The percentage that the sponsor is required to retain as a vertical interest under this section; and

(C) A description of the material terms of the vertical interest and the amount that the sponsor expects to retain at the closing of the securitization transaction.

(ii) A reasonable time after the closing of the securitization transaction, the amount of the vertical interest the sponsor retained at closing, if that amount is materially different from the amount disclosed under paragraph (c)(2)(i) of this section.

(d) *Record maintenance.* A sponsor must retain the certifications and disclosures required in paragraphs (a) and (c) of this section in its records and must provide the disclosure upon request to the Commission and its appropriate Federal banking agency, if any, until three years after all ABS interests are no longer outstanding.

§ __.5 Revolving pool securitizations.

(a) *Definitions.* For purposes of this section, the following definitions apply:

Revolving pool securitization means an issuing entity that is established to issue on multiple issuance dates more than one series, class, subclass, or tranche of asset-backed securities that are collateralized by a common pool of

securitized assets that will change in composition over time, and that does not monetize excess interest and fees from its securitized assets.

Seller's interest means an ABS interest or ABS interests:

(1) Collateralized by the securitized assets and servicing assets owned or held by the issuing entity, other than the following that are not considered a component of seller's interest:

(i) Servicing assets that have been allocated as collateral only for a specific series in connection with administering the revolving pool securitization, such as a principal accumulation or interest reserve account; and

(ii) Assets that are not eligible under the terms of the securitization transaction to be included when determining whether the revolving pool securitization holds aggregate securitized assets in specified proportions to aggregate outstanding investor ABS interests issued; and

(2) That is *pari passu* with each series of investor ABS interests issued, or partially or fully subordinated to one or more series in identical or varying amounts, with respect to the allocation of all distributions and losses with respect to the securitized assets prior to early amortization of the revolving securitization (as specified in the securitization transaction documents); and

(3) That adjusts for fluctuations in the outstanding principal balance of the securitized assets in the pool.

(b) *General requirement.* A sponsor satisfies the risk retention requirements of § __.3 with respect to a securitization transaction for which the issuing entity is a revolving pool securitization if the sponsor maintains a seller's interest of not less than 5 percent of the aggregate unpaid principal balance of all outstanding investor ABS interests in the issuing entity.

(c) *Measuring the seller's interest.* In measuring the seller's interest for purposes of meeting the requirements of paragraph (b) of this section:

(1) The unpaid principal balance of the securitized assets for the numerator of the 5 percent ratio shall not include assets of the types excluded from the definition of seller's interest in paragraph (a) of this section;

(2) The aggregate unpaid principal balance of outstanding investor ABS interests in the denominator of the 5 percent ratio may be reduced by the amount of funds held in a segregated principal accumulation account for the repayment of outstanding investor ABS interests, if:

(i) The terms of the securitization transaction documents prevent funds in the principal accumulation account from being applied for any purpose other than the repayment of the unpaid principal of outstanding investor ABS interests; and

(ii) Funds in that account are invested only in the types of assets in which funds held in an eligible horizontal cash reserve account pursuant to § __.4 are permitted to be invested;

(3) If the terms of the securitization transaction documents set minimum required seller's interest as a proportion of the unpaid principal balance of outstanding investor ABS interests for one or more series issued, rather than as a proportion of the aggregate outstanding investor ABS interests in all outstanding series combined, the percentage of the seller's interest for each such series must, when combined with the percentage of any minimum seller's interest set by reference to the aggregate outstanding investor ABS interests, equal at least 5 percent;

(4) The 5 percent test must be determined and satisfied at the closing of each issuance of ABS interests to investors by the issuing entity, and

(i) At least monthly at a seller's interest measurement date specified under the securitization transaction documents, until no ABS interest in the issuing entity is held by any person not a wholly-owned affiliate of the sponsor; or

(ii) If the revolving pool securitization fails to meet the 5 percent test as of any date described in paragraph (c)(4)(i) of this section, and the securitization transaction documents specify a cure period, the 5 percent test must be determined and satisfied within the earlier of the cure period, or one month after the date described in paragraph (c)(4)(i).

(d) *Measuring outstanding investor ABS interests.* In measuring the amount of outstanding investor ABS interests for purposes of this section, ABS interests held for the life of such ABS interests by the sponsor or its wholly-owned affiliates may be excluded.

(e) *Holding and retention of the seller's interest; legacy trusts.*

(1) Notwithstanding § __.12(a), the seller's interest, and any offsetting horizontal retention interest retained pursuant to paragraph (g) of this section, must be retained by the sponsor or by one or more wholly-owned affiliates of the sponsor, including one or more depositors of the revolving pool securitization.

(2) If one revolving pool securitization issues collateral certificates representing a beneficial interest in all or a portion of the securitized assets held by that securitization to another revolving pool securitization, which in turn issues ABS interests for which the collateral certificates are all or a portion of the securitized assets, a sponsor may satisfy the requirements of paragraphs (b) and (c) of this section by retaining the seller's interest for the assets represented by the collateral certificates through either of the revolving pool securitizations, so long as both revolving pool securitizations are retained at the direction of the same sponsor or its wholly-owned affiliates.

(3) If the sponsor retains the seller's interest associated with the collateral certificates at the level of the revolving pool securitization that issues those collateral certificates, the proportion of the seller's interest required by paragraph (b) of this section retained at that level must equal the proportion that the principal balance of the securitized assets represented by the collateral certificates bears to the principal balance of the securitized assets in the revolving pool securitization that issues the ABS interests, as of each measurement date required by paragraph (c) of this section.

(f) *Offset for pool-level excess funding account.* The 5 percent seller's interest required on each measurement date by paragraph (c) of this section may be reduced on a dollar-for-dollar basis by the balance, as of such date, of an excess funding account in the form of a segregated account that:

(1) Is funded in the event of a failure to meet the minimum seller's interest requirements or other requirement to maintain a minimum balance of securitized assets under the securitization transaction documents by distributions otherwise payable to the holder of the seller's interest;

(2) Is invested only in the types of assets in which funds held in a horizontal cash reserve account pursuant to § __.4 are permitted to be invested; and

(3) In the event of an early amortization, makes payments of amounts held in the account to holders of investor ABS interests in the same manner as payments to holders of investor ABS interests of amounts received on securitized assets.

(g) *Combined seller's interests and horizontal interest retention.* The 5 percent seller's interest required on each measurement date by paragraph (c) of this section may be reduced to a percentage lower than 5 percent to the extent that, for all series of investor ABS interests issued after the applicable effective date of this § __.5, the sponsor, or notwithstanding § __.12(a) a wholly-owned affiliate of the sponsor, retains, at a minimum, a corresponding

percentage of the fair value of ABS interests issued in each series, in the form of one or more of the horizontal residual interests meeting the requirements of paragraphs (h) or (i).

(h) *Residual ABS interests in excess interest and fees.* The sponsor may take the offset described in paragraph (g) of this section for a residual ABS interest in excess interest and fees, whether certificated or uncertificated, in a single or multiple classes, subclasses, or tranches, that meets, individually or in the aggregate, the requirements of this paragraph (h);

(1) Each series of the revolving pool securitization distinguishes between the series' share of the interest and fee cash flows and the series' share of the principal repayment cash flows from the securitized assets collateralizing the revolving pool securitization, which may according to the terms of the securitization transaction documents, include not only the series' ratable share of such cash flows but also excess cash flows available from other series;

(2) The residual ABS interest's claim to any part of the series' share of the interest and fee cash flows for any interest payment period is subordinated to all accrued and payable interest due on the payment date to more senior ABS interests in the series for that period, and further reduced by the series' share of losses, including defaults on principal of the securitized assets collateralizing the revolving pool securitization (whether incurred in that period or carried over from prior periods) to the extent that such payments would have been included in amounts payable to more senior interests in the series;

(3) The revolving pool securitization continues to revolve, with one or more series, classes, subclasses, or tranches of asset-backed securities that are collateralized by a common pool of assets that change in composition over time; and

(4) For purposes of taking the offset described in paragraph (g) of this section, the sponsor determines the fair value of the residual ABS interest in excess interest and fees, and the fair value of the series of outstanding investor ABS interests to which it is subordinated and supports using the fair value measurement framework under GAAP, as of:

(i) The closing of the securitization transaction issuing the supported ABS interests; and

(ii) The seller's interest measurement dates described in paragraph (c)(4) of this section, except that for these periodic determinations the sponsor must update the fair value of the residual ABS interest in excess interest and fees for the numerator of the percentage ratio, but may at the sponsor's option continue to use the fair values determined in (h)(4)(i) for the outstanding investor ABS interests in the denominator.

(i) *Offsetting eligible horizontal residual interest.* The sponsor may take the offset described in paragraph (g) of this section for ABS interests that would meet the definition of eligible horizontal residual interests in § __.2 but for the sponsor's simultaneous holding of subordinated seller's interests, residual ABS interests in excess interests and fees, or a combination of the two, if:

(1) The sponsor complies with all requirements of paragraphs (b) through (e) of this section for its holdings of subordinated seller's interest, and paragraph (h) for its holdings of residual ABS interests in excess interests and fees, as applicable;

(2) For purposes of taking the offset described in paragraph (g) of this section, the sponsor determines the fair value of the eligible horizontal residual interest as a percentage of the fair value of the outstanding investor ABS interests in the series supported by the eligible horizontal residual interest, determined using the fair value measurement framework under GAAP:

(i) As of the closing of the securitization transaction issuing the supported ABS interests; and

(ii) Without including in the numerator of the percentage ratio any fair value based on:

(A) The subordinated seller's interest or residual ABS interest in excess interest and fees;

(B) the interest payable to the sponsor on the eligible horizontal residual interest, if the sponsor is including the value of residual ABS interest in excess interest and fees pursuant to paragraph (h) of this section in taking the offset in paragraph (g) of this section; and,

(C) the principal payable to the sponsor on the eligible horizontal residual interest, if the sponsor is including the value of the seller's interest pursuant to paragraphs (b) through (f) of this section and distributions on that seller's interest are available to reduce charge-offs that would otherwise be allocated to reduce principal payable to the offset eligible horizontal residual interest.

(j) *Specified dates.* A sponsor using data about the revolving pool securitization's collateral, or ABS interests previously issued, to determine the closing-date percentage of a seller's interest, residual ABS interest in excess interest and fees, or eligible horizontal residual interest pursuant to this § __.5 may use such data prepared as of specified dates if:

(1) The sponsor describes the specified dates in the disclosures required by paragraph (k) of this section; and

(2) The dates are no more than 60 days prior to the date of first use with investors of disclosures required for the interest by paragraph (k) of this section, or for revolving pool securitizations that make distributions to investors on a quarterly or less frequent basis, no more than 135 days prior to the date of first use with investors of such disclosures.

(k) *Disclosure and record maintenance.* (1) *Disclosure.* A sponsor relying on this section shall provide, or cause to be provided, to potential investors, under the caption ''Credit Risk Retention'' the following disclosure in written form and within the time frames set forth in this paragraph (k):

(i) A reasonable period of time prior to the sale of an asset-backed security, a description of the material terms of the seller's interest, and the percentage of the seller's interest that the sponsor expects to retain at the closing of the securitization transaction, measured in accordance with the requirements of this § __.5, as a percentage of the aggregate unpaid principal balance of all outstanding investor ABS interests issued, or as a percentage of the aggregate unpaid principal balance of outstanding investor ABS interests for one or more series issued, as required by the terms of the securitization transaction;

(ii) A reasonable time after the closing of the securitization transaction, the amount of seller's interest the sponsor retained at closing, if that amount is materially different from the amount disclosed under paragraph (k)(1)(i) of this section; and

(iii) A description of the material terms of any horizontal residual interests offsetting the seller's interest in accordance with paragraphs (g), (h), and (i) of this section; and

(iv) Disclosure of the fair value of those horizontal residual interests retained by the sponsor for the series being offered to investors and described in the disclosures, as a percentage of the fair value of the outstanding investor ABS interests issued, described in the same manner and within the same timeframes required for disclosure of the fair values of eligible horizontal residual interests specified in § __.4(c).

(2) *Adjusted data.* Disclosures required by this paragraph (k) to be made a reasonable period of time prior to the sale of an asset-backed security of the amount of seller's interest, residual ABS interest in excess interest and fees,

or eligible horizontal residual interest may include adjustments to the amount of securitized assets for additions or removals the sponsor expects to make before the closing date and adjustments to the amount of outstanding investor ABS interests for expected increases and decreases of those interests under the control of the sponsor.

(3) *Record maintenance.* A sponsor must retain the disclosures required in paragraph (k)(1) of this section in its records and must provide the disclosure upon request to the Commission and its appropriate Federal banking agency, if any, until three years after all ABS interests are no longer outstanding.

(l) *Early amortization of all outstanding series.* A sponsor that organizes a revolving pool securitization that relies on this § __.5 to satisfy the risk retention requirements of § __.3, does not violate the requirements of this part if its seller's interest falls below the level required by § __. 5 after the revolving pool securitization commences early amortization, pursuant to the terms of the securitization transaction documents, of all series of outstanding investor ABS interests, if:

(1) The sponsor was in full compliance with the requirements of this section on all measurement dates specified in paragraph (c) of this section prior to the commencement of early amortization;

(2) The terms of the seller's interest continue to make it *pari passu* with or subordinate in identical or varying amounts to each series of outstanding investor ABS interests issued with respect to the allocation of all distributions and losses with respect to the securitized assets;

(3) The terms of any horizontal interest relied upon by the sponsor pursuant to paragraph (g) to offset the minimum seller's interest amount continue to require the interests to absorb losses in accordance with the terms of paragraph (h) or (i) of this section, as applicable; and

(4) The revolving pool securitization issues no additional ABS interests after early amortization is initiated to any person not a wholly-owned affiliate of the sponsor, either at the time of issuance or during the amortization period.

§ ____.6 Eligible ABCP conduits.

(a) *Definitions.* For purposes of this section, the following additional definitions apply:

100 percent liquidity coverage means an amount equal to the outstanding balance of all ABCP issued by the conduit plus any accrued and unpaid interest without regard to the performance of the ABS interests held by the ABCP conduit and without regard to any credit enhancement.

ABCP means asset-backed commercial paper that has a maturity at the time of issuance not exceeding 397 days, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

ABCP conduit means an issuing entity with respect to ABCP.

Eligible ABCP conduit means an ABCP conduit, *provided that:*

(1) The ABCP conduit is bankruptcy remote or otherwise isolated for insolvency purposes from the sponsor of the ABCP conduit and from any intermediate SPV;

(2) The ABS interests acquired by the ABCP conduit are:

(i) ABS interests collateralized solely by assets originated by an originator-seller and by servicing assets;

(ii) Special units of beneficial interest (or similar ABS interests) in a trust or special purpose vehicle 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 described in paragraph (2)(i), (ii), or (iii) of this definition 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 are assets described in paragraph (2)(i), (ii), or (iii) of this definition; and

(v) Acquired by the ABCP conduit in an initial issuance by or on behalf of an intermediate SPV:

(A) Directly from the intermediate SPV,

(B) From an underwriter of the ABS interests issued by the intermediate SPV, or

(C) From another person who acquired the ABS interests directly from the intermediate SPV;

(3) The ABCP conduit is collateralized solely by ABS interests acquired from intermediate SPVs as described in paragraph (2) of this definition and servicing assets; and

(4) A regulated liquidity provider has entered into a legally binding commitment to provide 100 percent liquidity coverage (in the form of a lending facility, an asset purchase agreement, a repurchase agreement, or other similar arrangement) to all the ABCP issued by the ABCP conduit by lending to, purchasing ABCP issued by, or purchasing assets from, the ABCP conduit in the event that funds are required to repay maturing ABCP issued by the ABCP conduit. With respect to the 100 percent liquidity coverage, in the event that the ABCP conduit is unable for any reason to repay maturing ABCP issued by the issuing entity, the liquidity provider shall be obligated to pay an amount equal to any shortfall, and the total amount that may be due pursuant to the 100 percent liquidity coverage shall be equal to 100 percent of the amount of the ABCP outstanding at any time plus accrued and unpaid interest (amounts due pursuant to the required liquidity coverage may not be subject to credit performance of the ABS interests held by the ABCP conduit or reduced by the amount of credit support provided to the ABCP conduit and liquidity support that only funds performing loans or receivables or performing ABS interests does not meet the requirements of this section).

Intermediate SPV means a special purpose vehicle that:

(1) (i) Is a direct or indirect wholly-owned affiliate of the originator-seller; or

(ii) Has nominal equity owned by a trust or corporate service provider that specializes in providing independent ownership of special purpose vehicles, and such trust or corporate service provider is not affiliated with any other transaction parties;

(2) Is bankruptcy remote or otherwise isolated for insolvency purposes from the eligible ABCP conduit and from each originator-seller and each majority-owned affiliate in each case that, directly or indirectly, sells or transfers assets to such intermediate SPV;

(3) Acquires assets from the originator-seller that are originated by the originator-seller or acquired by the originator-seller in the acquisition of a business that qualifies for business combination accounting under GAAP or acquires ABS interests issued by another intermediate SPV of the originator-seller that are collateralized solely by such assets; and

(4) Issues ABS interests collateralized solely by such assets, as applicable.

Originator-seller means an entity that originates assets and sells or transfers those assets, directly or through a majority-owned affiliate, to an intermediate SPV, and includes (except for the purposes of identifying the sponsorship and affiliation of an intermediate SPV pursuant to this § __.6) any affiliate of the originator-

seller that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, the originator-seller. 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.

Regulated liquidity provider means:

(1) A depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813));

(2) A bank holding company (as defined in 12 U.S.C. 1841), or a subsidiary thereof;

(3) A savings and loan holding company (as defined in 12 U.S.C. 1467a), provided all or substantially all of the holding company's activities are permissible for a financial holding company under 12 U.S.C. 1843(k), or a subsidiary thereof; or

(4) A foreign bank whose home country supervisor (as defined in § 211.21 of the Federal Reserve Board's Regulation K (12 CFR 211.21)) has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision, as amended, and that is subject to such standards, or a subsidiary thereof.

(b) *In general.* An ABCP conduit sponsor satisfies the risk retention requirement of § __.3 with respect to the issuance of ABCP by an eligible ABCP conduit in a securitization transaction if, for each ABS interest the ABCP conduit acquires from an intermediate SPV:

(1) An originator-seller of the intermediate SPV retains an economic interest in the credit risk of the assets collateralizing the ABS interest acquired by the eligible ABCP conduit in the amount and manner required under § __.4 or § __.5; and

(2) The ABCP conduit sponsor:

(i) Approves each originator-seller permitted to sell or transfer assets, directly or indirectly, to an intermediate SPV from which an eligible ABCP conduit acquires ABS interests;

(ii) Approves each intermediate SPV from which an eligible ABCP conduit is permitted to acquire ABS interests;

(iii) Establishes criteria governing the ABS interests, and the securitized assets underlying the ABS interests, acquired by the ABCP conduit;

(iv) Administers the ABCP conduit by monitoring the ABS interests acquired by the ABCP conduit and the assets supporting those ABS interests, arranging for debt placement, compiling monthly reports, and ensuring compliance with the ABCP conduit documents and with the ABCP conduit's credit and investment policy; and

(v) Maintains and adheres to policies and procedures for ensuring that the requirements in this paragraph (b) of this section have been met.

(c) *Originator-seller compliance with risk retention.* The use of the risk retention option provided in this section by an ABCP conduit sponsor does not relieve the originator-seller that sponsors ABS interests acquired by an eligible ABCP conduit from such originator-seller's obligation to comply with its own risk retention obligations under this part.

(d) *Disclosures*—(1) *Periodic disclosures to investors.* An ABCP conduit sponsor relying upon this section shall provide, or cause to be provided, to each purchaser of ABCP, before or contemporaneously with the first sale of ABCP to such purchaser and at least monthly thereafter, to each holder of commercial paper issued by the ABCP conduit, in writing, each of the following items of information, which shall be as of a date not more than 60 days prior to date of first use with investors:

(i) The name and form of organization of the regulated liquidity provider that provides liquidity coverage to the eligible ABCP conduit, including a description of the material terms of such liquidity coverage, and notice of any failure to fund.

(ii) With respect to each ABS interest held by the ABCP conduit:

(A) The asset class or brief description of the underlying securitized assets;

(B) The standard industrial category code (SIC Code) for the originator-seller that will retain (or has retained) pursuant to this section an interest in the securitization transaction; and

(C) A description of the percentage amount of risk retention pursuant to the rule by the originator-seller, and whether it is in the form of an eligible horizontal residual interest, vertical interest, or revolving pool securitization seller's interest, as applicable.

(2) *Disclosures to regulators regarding originator-sellers.* An ABCP conduit sponsor relying upon this section shall provide, or cause to be provided, upon request, to the Commission and its appropriate Federal banking agency, if any, in writing, all of the information required to be provided to investors in paragraph (d)(1) of this section, and the name and form of organization of each originator-seller that will retain (or has retained) pursuant to this section an interest in the securitization transaction.

(e) *Sale or transfer of ABS interests between eligible ABCP conduits.* At any time, an eligible ABCP conduit that acquired an ABS interest in accordance with the requirements set forth in this section may transfer, and another eligible ABCP conduit may acquire, such ABS interest, if the following conditions are satisfied:

(1) The sponsors of both eligible ABCP conduits are in compliance with this section; and

(2) The same regulated liquidity provider has entered into one or more legally binding commitments to provide 100 percent liquidity coverage to all the ABCP issued by both eligible ABCP conduits.

(f) *Duty to comply.* (1) The ABCP conduit sponsor shall be responsible for compliance with this section.

(2) An ABCP conduit sponsor relying on this section:

(i) Shall maintain and adhere to policies and procedures that are reasonably designed to monitor compliance by each originator-seller which is satisfying a risk retention obligation in respect of ABS interests acquired by an eligible ABCP conduit with the requirements of paragraph (b)(1) of this section; and

(ii) In the event that the ABCP conduit sponsor determines that an originator-seller no longer complies with the requirements of paragraph (b)(1) of this section, shall:

(A) Promptly notify the holders of the ABCP, and upon request, the Commission and its appropriate Federal banking agency, if any, in writing of:

(*1*) The name and form of organization of any originator-seller that fails to retain risk in accordance with paragraph (b)(1) of this section and the amount of ABS interests issued by an intermediate SPV of such originator-seller and held by the ABCP conduit;

(*2*) The name and form of organization of any originator-seller that hedges, directly or indirectly through an intermediate SPV, its risk retention in violation of paragraph (b)(1) of this section and the amount of ABS interests issued by an intermediate SPV of such originator-seller and held by the ABCP conduit; and

(*3*) Any remedial actions taken by the ABCP conduit sponsor or other party with respect to such ABS interests; and

(B) Take other appropriate steps pursuant to the requirements of paragraphs (b)(2)(iv) and (v) of this section which may include, as appropriate, curing any breach of the requirements in this section, or removing from the eligible ABCP conduit any ABS interest that does not comply with the requirements in this section.

§ __.7 Commercial mortgage-backed securities.

(a) *Definitions.* For purposes of this section, the following definition shall apply:

Special servicer means, with respect to any securitization of commercial real estate loans, any servicer that, upon the occurrence of one or more specified conditions in the servicing agreement, has the right to service one or more assets in the transaction.

(b) *Third-party purchaser.* A sponsor may satisfy some or all of its risk retention requirements under § __.3 with respect to a securitization transaction if a third party (or any majority-owned affiliate thereof) purchases and holds for its own account an eligible horizontal residual interest in the issuing entity in the same form, amount, and manner as would be held by the sponsor under § __.4 and all of the following conditions are met:

(1) *Number of third-party purchasers.* At any time, there are no more than two third-party purchasers of an eligible horizontal residual interest. If there are two third-party purchasers, each third-party purchaser's interest must be *pari passu* with the other third-party purchaser's interest.

(2) *Composition of collateral.* The securitization transaction is collateralized solely by commercial real estate loans and servicing assets.

(3) *Source of funds.* (i) Each third-party purchaser pays for the eligible horizontal residual interest in cash at the closing of the securitization transaction.

(ii) No third-party purchaser obtains financing, directly or indirectly, for the purchase of such interest from any other person that is a party to, or an affiliate of a party to, the securitization transaction (including, but not limited to, the sponsor, depositor, or servicer other than a special servicer affiliated with the third-party purchaser), other than a person that is a party to the transaction solely by reason of being an investor.

(4) *Third-party review.* Each third-party purchaser conducts an independent review of the credit risk of each securitized asset prior to the sale of the asset-backed securities in the securitization transaction that includes, at a minimum, a review of the underwriting standards, collateral, and expected cash flows of each commercial real estate loan that is collateral for the asset-backed securities.

(5) *Affiliation and control rights.* (i) Except as provided in paragraph (b)(5)(ii) of this section, no third-party purchaser is affiliated with any party to the securitization transaction (including, but not limited to, the sponsor, depositor, or servicer) other than investors in the securitization transaction.

(ii) Notwithstanding paragraph (b)(5)(i) of this section, a third-party purchaser may be affiliated with:

(A) The special servicer for the securitization transaction; or

(B) One or more originators of the securitized assets, as long as the assets originated by the affiliated originator or originators collectively comprise less than 10 percent of the unpaid principal balance of the securitized assets included in the securitization transaction at the cut-off date or similar date for establishing the composition of the securitized assets collateralizing the asset-backed securities issued pursuant to the securitization transaction.

(6) *Operating Advisor.* The underlying securitization transaction documents shall provide for the following:

(i) The appointment of an operating advisor (the Operating Advisor) that:

(A) Is not affiliated with other parties to the securitization transaction;

(B) Does not directly or indirectly have any financial interest in the securitization transaction other than in fees from its role as Operating Advisor; and

(C) Is required to act in the best interest of, and for the benefit of, investors as a collective whole;

(ii) Standards with respect to the Operating Advisor's experience, expertise and financial strength to fulfill its duties and responsibilities under the applicable transaction documents over the life of the securitization transaction;

(iii) The terms of the Operating Advisor's compensation with respect to the securitization transaction;

(iv) When the eligible horizontal residual interest has been reduced by principal payments, realized losses, and appraisal reduction amounts (which reduction amounts are determined in accordance with the applicable transaction documents) to a principal balance of 25 percent or less of its initial principal balance, the special servicer for the securitized assets must consult with the Operating Advisor in connection with, and prior to, any material decision in connection with its servicing of the securitized assets, including, without limitation:

(A) Any material modification of, or waiver with respect to, any provision of a loan agreement (including a mortgage, deed of trust, or other security agreement);

(B) Foreclosure upon or comparable conversion of the ownership of a property; or

(C) Any acquisition of a property.

(v) The Operating Advisor shall have adequate and timely access to information and reports necessary to fulfill its duties under the transaction documents, including all reports made available to holders of ABS interests and third-party purchasers, and shall be responsible for:

(A) Reviewing the actions of the special servicer;

(B) Reviewing all reports provided by the special servicer to the issuing entity or any holder of ABS interests;

(C) Reviewing for accuracy and consistency with the transaction documents calculations made by the special servicer; and

(D) Issuing a report to investors (including any third-party purchasers) and the issuing entity on a periodic basis concerning:

(*1*) Whether the Operating Advisor believes, in its sole discretion exercised in good faith, that the special servicer is operating in compliance with any standard required of the special servicer in the applicable transaction documents; and

(*2*) Which, if any, standards the Operating Advisor believes, in its sole discretion exercised in good faith, the special servicer has failed to comply.

(vi)(A) The Operating Advisor shall have the authority to recommend that the special servicer be replaced by a successor special servicer if the Operating Advisor determines, in its sole discretion exercised in good faith, that:

(*1*) The special servicer has failed to comply with a standard required of the special servicer in the applicable transaction documents; and

(*2*) Such replacement would be in the best interest of the investors as a collective whole; and

(B) If a recommendation described in paragraph (b)(6)(vi)(A) of this section is made, the special servicer shall be replaced upon the affirmative vote of a majority of the outstanding principal balance of all ABS interests voting on the matter, with a minimum of a quorum of ABS interests voting on the matter. For purposes of such vote, the applicable transaction documents shall specify the quorum and may not specify a quorum of more than the holders of 20 percent of the outstanding principal balance of all ABS interests in the issuing entity, with such quorum including at least three ABS interest holders that are not affiliated with each other.

(7) *Disclosures.* The sponsor provides, or causes to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities as part of the securitization

transaction and, upon request, to the Commission and its appropriate Federal banking agency, if any, the following disclosure in written form under the caption ''Credit Risk Retention'':

(i) The name and form of organization of each initial third-party purchaser that acquired an eligible horizontal residual interest at the closing of a securitization transaction;

(ii) A description of each initial third-party purchaser's experience in investing in commercial mortgage-backed securities;

(iii) Any other information regarding each initial third-party purchaser or each initial third-party purchaser's retention of the eligible horizontal residual interest that is material to investors in light of the circumstances of the particular securitization transaction;

(iv) The fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS interests are issued, as applicable)) of the eligible horizontal residual interest that will be retained (or was retained) by each initial third-party purchaser, as well as the amount of the purchase price paid by each initial third-party purchaser for such interest;

(v) The fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS interests are issued, as applicable)) of the eligible horizontal residual interest in the securitization transaction that the sponsor would have retained pursuant to § __.4 if the sponsor had relied on retaining an eligible horizontal residual interest in that section to meet the requirements of § __.3 with respect to the transaction;

(vi) A description of the material terms of the eligible horizontal residual interest retained by each initial third-party purchaser, including the same information as is required to be disclosed by sponsors retaining horizontal interests pursuant to § __.4;

(vii) The material terms of the applicable transaction documents with respect to the Operating Advisor, including without limitation:

(A) The name and form of organization of the Operating Advisor;

(B) A description of any material conflict of interest or material potential conflict of interest between the Operating Advisor and any other party to the transaction;

(C) The standards required by paragraph (b)(6)(ii) of this section and a description of how the Operating Advisor satisfies each of the standards; and

(D) The terms of the Operating Advisor's compensation under paragraph (b)(6)(iii) of this section; and

(viii) The representations and warranties concerning the securitized assets, a schedule of any securitized assets that are determined not to comply with such representations and warranties, and what factors were used to make the determination that such securitized assets should be included in the pool notwithstanding that the securitized assets did not comply with such representations and warranties, such as compensating factors or a determination that the exceptions were not material.

(8) *Hedging, transfer and pledging*—(i) *General rule.* Except as set forth in paragraph (b)(8)(ii) of this section, each third-party purchaser and its affiliates must comply with the hedging and other restrictions in § __.12 as if it were the retaining sponsor with respect to the securitization transaction and had acquired the eligible horizontal residual interest pursuant to § __.4; provided that, the hedging and other restrictions in § __.12 shall not apply on or after the date that each CRE loan (as defined in § __.14) that serves as collateral for outstanding ABS interests has been defeased. For purposes of this section, a loan is deemed to be defeased if:

(A) cash or cash equivalents of the types permitted for an eligible horizontal cash reserve account pursuant to § __.4 whose maturity corresponds to the remaining debt service obligations, have been pledged to the issuing entity as collateral for the loan and are in such amounts and payable at such times as necessary to timely generate cash sufficient to make all remaining debt service payments due on such loan; and

(B) the issuing entity has an obligation to release its lien on the loan.

(ii) *Exceptions*—(A) *Transfer by initial third-party purchaser or sponsor.* An initial third-party purchaser that acquired an eligible horizontal residual interest at the closing of a securitization transaction in accordance with this section, or a sponsor that acquired an eligible horizontal residual interest at the closing of a securitization transaction in accordance with this section, may, on or after the date that is five years after the date of the closing of the securitization transaction, transfer that interest to a subsequent third-party purchaser that complies with paragraph (b)(8)(ii)(C) of this section. The initial third-party purchaser shall provide the sponsor with complete identifying information for the subsequent third-party purchaser.

(B) *Transfer by subsequent third-party purchaser.* At any time, a subsequent third-party purchaser that acquired an eligible horizontal residual interest pursuant to this section may transfer its interest to a different third-party purchaser that complies with paragraph (b)(8)(ii)(C) of this section. The transferring third-party purchaser shall provide the sponsor with complete identifying information for the acquiring third-party purchaser.

(C) *Requirements applicable to subsequent third-party purchasers.* A subsequent third-party purchaser is subject to all of the requirements of paragraphs (b)(1), (b)(3) through (5), and (b)(8) of this section applicable to third-party purchasers, provided that obligations under paragraphs (b)(1), (b)(3) through (5), and (b)(8) of this section that apply to initial third-party purchasers at or before the time of closing of the securitization transaction shall apply to successor third-party purchasers at or before the time of the transfer of the eligible horizontal residual interest to the successor third-party purchaser.

(c) *Duty to comply.* (1) The retaining sponsor shall be responsible for compliance with this section by itself and for compliance by each initial or subsequent third-party purchaser that acquired an eligible horizontal residual interest in the securitization transaction.

(2) A sponsor relying on this section:

(i) Shall maintain and adhere to policies and procedures to monitor each third-party purchaser's compliance with the requirements of paragraphs (b)(1), (b)(3) through (5), and (b)(8) of this section; and

(ii) In the event that the sponsor determines that a third-party purchaser no longer complies with one or more of the requirements of paragraphs (b)(1), (b)(3) through (5), or (b)(8) of this section, shall promptly notify, or cause to be notified, the holders of the ABS interests issued in the securitization transaction of such noncompliance by such third-party purchaser.

§ __.8 Federal National Mortgage Association and Federal Home Loan Mortgage Corporation ABS.

(a) *In general.* A sponsor satisfies its risk retention requirement under this part if the sponsor fully guarantees the timely payment of principal and interest on all ABS interests issued by the issuing entity in the securitization transaction and is:

(1) The Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation operating under

the conservatorship or receivership of the Federal Housing Finance Agency pursuant to section 1367 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4617) with capital support from the United States; or

(2) Any limited-life regulated entity succeeding to the charter of either the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation pursuant to section 1367(i) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4617(i)), provided that the entity is operating with capital support from the United States.

(b) *Certain provisions not applicable.* The provisions of § __.12(b), (c), and (d) shall not apply to a sponsor described in paragraph (a)(1) or (2) of this section, its affiliates, or the issuing entity with respect to a securitization transaction for which the sponsor has retained credit risk in accordance with the requirements of this section.

(c) *Disclosure.* A sponsor relying on this section shall provide to investors, in written form under the caption ''Credit Risk Retention'' and, upon request, to the Federal Housing Finance Agency and the Commission, a description of the manner in which it has met the credit risk retention requirements of this part.

§ __.9 Open market CLOs.

(a) *Definitions.* For purposes of this section, the following definitions shall apply:

CLO means a special purpose entity that:

(i) Issues debt and equity interests, and

(ii) Whose assets consist primarily of loans that are securitized assets and servicing assets.

CLO-eligible loan tranche means a term loan of a syndicated facility that meets the criteria set forth in paragraph (c) of this section.

CLO manager means an entity that manages a CLO, which entity is registered as an investment adviser under the Investment Advisers Act of 1940, as amended (15 U.S.C. 80b-1 *et seq.*), or is an affiliate of such a registered investment adviser and itself is managed by such registered investment adviser.

Commercial borrower means an obligor under a corporate credit obligation (including a loan).

Initial loan syndication transaction means a transaction in which a loan is syndicated to a group of lenders.

Lead arranger means, with respect to a CLO-eligible loan tranche, an institution that:

(i) Is active in the origination, structuring and syndication of commercial loan transactions (as defined in § __.14) and has played a primary role in the structuring, underwriting and distribution on the primary market of the CLO-eligible loan tranche.

(ii) Has taken an allocation of the funded portion of the syndicated credit facility under the terms of the transaction that includes the CLO-eligible loan tranche of at least 20 percent of the aggregate principal balance at origination, and no other member (or members affiliated with each other) of the syndication group that funded at origination has taken a greater allocation; and

(iii) Is identified in the applicable agreement governing the CLO-eligible loan tranche; represents therein to the holders of the CLO-eligible loan tranche and to any holders of participation interests in such CLO-eligible loan tranche that such lead arranger satisfies the requirements of paragraph (i) of this definition and, at the time of initial funding of the CLO-eligible tranche, will satisfy the requirements of paragraph (ii) of this definition; further represents therein (solely for the purpose of assisting such holders to determine the eligibility of such CLO-eligible loan tranche to be held by an open market CLO) that in the reasonable judgment of such lead arranger, the terms of such CLO-eligible loan tranche are consistent with the requirements of paragraphs (c)(2) and (3) of this section; and covenants therein to such holders that such lead arranger will fulfill the requirements of paragraph (c)(1) of this section.

Open market CLO means a CLO:

(i) Whose assets consist of senior, secured syndicated loans acquired by such CLO directly from the sellers thereof in open market transactions and of servicing assets,

(ii) That is managed by a CLO manager, and

(iii) That holds less than 50 percent of its assets, by aggregate outstanding principal amount, in loans syndicated by lead arrangers that are affiliates of the CLO or the CLO manager or originated by originators that are affiliates of the CLO or the CLO manager.

Open market transaction means:

(i) Either an initial loan syndication transaction or a secondary market transaction in which a seller offers senior, secured syndicated loans to prospective purchasers in the loan market on market terms on an arm's length basis, which prospective purchasers include, but are not limited to, entities that are not affiliated with the seller, or

(ii) A reverse inquiry from a prospective purchaser of a senior, secured syndicated loan through a dealer in the loan market to purchase a senior, secured syndicated loan to be sourced by the dealer in the loan market.

Secondary market transaction means a purchase of a senior, secured syndicated loan not in connection with an initial loan syndication transaction but in the secondary market.

Senior, secured syndicated loan means a loan made to a commercial borrower that:

(i) Is not subordinate in right of payment to any other obligation for borrowed money of the commercial borrower,

(ii) Is secured by a valid first priority security interest or lien in or on specified collateral securing the commercial borrower's obligations under the loan, and

(iii) The value of the collateral subject to such first priority security interest or lien, together with other attributes of the obligor (including, without limitation, its general financial condition, ability to generate cash flow available for debt service and other demands for that cash flow), is adequate (in the commercially reasonable judgment of the CLO manager exercised at the time of investment) to repay the loan and to repay all other indebtedness of equal seniority secured by such first priority security interest or lien in or on the same collateral, and the CLO manager certifies, on or prior to each date that it acquires a loan constituting part of a new CLO-eligible tranche, that it has policies and procedures to evaluate the likelihood of repayment of loans acquired by the CLO and it has followed such policies and procedures in evaluating each CLO-eligible loan tranche.

(b) *In general.* A sponsor satisfies the risk retention requirements of § __.3 with respect to an open market CLO transaction if:

(1) The open market CLO does not acquire or hold any assets other than CLO-eligible loan tranches that meet the requirements of paragraph (c) of this section and servicing assets;

(2) The governing documents of such open market CLO require that, at all times, the assets of the open market CLO consist of senior, secured syndicated loans that are CLO-eligible loan tranches and servicing assets;

(3) The open market CLO does not invest in ABS interests or in credit derivatives other than hedging

transactions that are servicing assets to hedge risks of the open market CLO;

(4) All purchases of CLO-eligible loan tranches and other assets by the open market CLO issuing entity or through a warehouse facility used to accumulate the loans prior to the issuance of the CLO's ABS interests are made in open market transactions on an arms-length basis;

(5) The CLO manager of the open market CLO is not entitled to receive any management fee or gain on sale at the time the open market CLO issues its ABS interests.

(c) *CLO-eligible loan tranche.* To qualify as a CLO-eligible loan tranche, a term loan of a syndicated credit facility to a commercial borrower must have the following features:

(1) A minimum of 5 percent of the face amount of the CLO-eligible loan tranche is retained by the lead arranger thereof until the earliest of the repayment, maturity, involuntary and unscheduled acceleration, payment default, or bankruptcy default of such CLO-eligible loan tranche, provided that such lead arranger complies with limitations on hedging, transferring and pledging in § __.12 with respect to the interest retained by the lead arranger.

(2) Lender voting rights within the credit agreement and any intercreditor or other applicable agreements governing such CLO-eligible loan tranche are defined so as to give holders of the CLO-eligible loan tranche consent rights with respect to, at minimum, any material waivers and amendments of such applicable documents, including but not limited to, adverse changes to the calculation or payments of amounts due to the holders of the CLO-eligible tranche, alterations to *pro rata* provisions, changes to voting provisions, and waivers of conditions precedent; and

(3) The pro rata provisions, voting provisions, and similar provisions applicable to the security associated with such CLO-eligible loan tranches under the CLO credit agreement and any intercreditor or other applicable agreements governing such CLO-eligible loan tranches are not materially less advantageous to the holder(s) of such CLO-eligible tranche than the terms of other tranches of comparable seniority in the broader syndicated credit facility.

(d) *Disclosures.* A sponsor relying on this section shall provide, or cause to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities in the securitization transaction and at least annually with respect to the information required by paragraph (d)(1) of this section and, upon request, to the Commission and its appropriate Federal banking agency, if any, the following disclosure in written form under the caption ''Credit Risk Retention'':

(1) *Open market CLOs.* A complete list of every asset held by an open market CLO (or before the CLO's closing, in a warehouse facility in anticipation of transfer into the CLO at closing), including the following information:

(i) The full legal name, Standard Industrial Classification (SIC) category code, and legal entity identifier (LEI) issued by a utility endorsed or otherwise governed by the Global LEI Regulatory Oversight Committee or the Global LEI Foundation (if an LEI has been obtained by the obligor) of the obligor of the loan or asset;

(ii) The full name of the specific loan tranche held by the CLO;

(iii) The face amount of the entire loan tranche held by the CLO, and the face amount of the portion thereof held by the CLO;

(iv) The price at which the loan tranche was acquired by the CLO; and

(v) For each loan tranche, the full legal name of the lead arranger subject to the sales and hedging restrictions of § __.12; and

(2) *CLO manager.* The full legal name and form of organization of the CLO manager.

§ __.10 Qualified tender option bonds.

(a) *Definitions.* For purposes of this section, the following definitions shall apply:

Municipal security or *municipal securities* shall have the same meaning as the term ''municipal securities'' in Section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29)) and any rules promulgated pursuant to such section.

Qualified tender option bond entity means an issuing entity with respect to tender option bonds for which each of the following applies:

(i) Such entity is collateralized solely by servicing assets and by municipal securities that have the same municipal issuer and the same underlying obligor or source of payment (determined without regard to any third-party credit enhancement), and such municipal securities are not subject to substitution.

(ii) Such entity issues no securities other than:

(A) A single class of tender option bonds with a preferred variable return payable out of capital that meets the requirements of paragraph (b) of this section, and

(B) One or more residual equity interests that, in the aggregate, are entitled to all remaining income of the issuing entity.

(C) The types of securities referred to in paragraphs (ii)(A) and (B) of this definition must constitute asset-backed securities.

(iii) The municipal securities held as assets by such entity are issued in compliance with Section 103 of the Internal Revenue Code of 1986, as amended (the ''IRS Code'', 26 U.S.C. 103), such that the interest payments made on those securities are excludable from the gross income of the owners under Section 103 of the IRS Code.

(iv) The terms of all of the securities issued by the entity are structured so that all holders of such securities who are eligible to exclude interest received on such securities will be able to exclude that interest from gross income pursuant to Section 103 of the IRS Code or as ''exempt-interest dividends'' pursuant to Section 852(b)(5) of the IRS Code (26 U.S.C. 852(b)(5)) in the case of regulated investment companies under the Investment Company Act of 1940, as amended.

(v) Such entity has a legally binding commitment from a regulated liquidity provider as defined in § __.6(a), to provide a 100 percent guarantee or liquidity coverage with respect to all of the issuing entity's outstanding tender option bonds.

(vi) Such entity qualifies for monthly closing elections pursuant to IRS Revenue Procedure 2003–84, as amended or supplemented from time to time.

Tender option bond means a security which has features which entitle the holders to tender such bonds to the issuing entity for purchase at any time upon no more than 397 days' notice, for a purchase price equal to the approximate amortized cost of the security, plus accrued interest, if any, at the time of tender.

(b) *Risk retention options.* Notwithstanding anything in this section, the sponsor with respect to an issuance of tender option bonds may retain an eligible vertical interest or eligible horizontal residual interest, or any combination thereof, in accordance with the requirements of § __.4. In order to satisfy its risk retention requirements under this section, the sponsor with respect to an issuance of tender option bonds by a qualified tender option bond entity may retain:

(1) An eligible vertical interest or an eligible horizontal residual interest, or any combination thereof, in accordance with the requirements of § __.4; or

(2) An interest that meets the requirements set forth in paragraph (c) of this section; or

(3) A municipal security that meets the requirements set forth in paragraph (d) of this section; or

(4) Any combination of interests and securities described in paragraphs (b)(1) through (b)(3) of this section such that the sum of the percentages held in each form equals at least five.

(c) *Tender option termination event.* The sponsor with respect to an issuance of tender option bonds by a qualified tender option bond entity 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 the requirements of an eligible vertical interest.

(d) *Retention of a municipal security outside of the qualified tender option bond entity.* The sponsor with respect to an issuance of tender option bonds by a qualified tender option bond entity may satisfy its risk retention requirements under this Section 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.

(e) *Disclosures.* The sponsor shall provide, or cause to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities as part of the securitization transaction and, upon request, to the Commission and its appropriate Federal banking agency, if any, the following disclosure in written form under the caption ''Credit Risk Retention'':

(1) The name and form of organization of the qualified tender option bond entity;

(2) A description of the form and subordination features of such retained interest in accordance with the disclosure obligations in § __.4(c);

(3) To the extent any portion of the retained interest is claimed by the sponsor as an eligible horizontal residual interest (including any interest held in compliance with § __.10(c)), the fair value of that interest (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and as a dollar amount);

(4) To the extent any portion of the retained interest is claimed by the sponsor as an eligible vertical interest (including any interest held in compliance with § __.10(c)), the percentage of ABS interests issued represented by the eligible vertical interest; and

(5) To the extent any portion of the retained interest claimed by the sponsor is a municipal security held outside of the qualified tender option bond entity, the name and form of organization of the qualified tender option bond entity, the identity of the issuer of the municipal securities, the face value of the municipal securities deposited into the qualified tender option bond entity, and the face value of the municipal securities retained by the sponsor or its majority-owned affiliates and subject to the transfer and hedging prohibition.

(f) *Prohibitions on Hedging and Transfer.* The prohibitions on transfer and hedging set forth in § __.12, apply to any interests or municipal securities retained by the sponsor with respect to an issuance of tender option bonds by a qualified tender option bond entity pursuant to of this section.

Subpart C—Transfer of Risk Retention

§ __.11 Allocation of risk retention to an originator.

(a) *In general.* A sponsor choosing to retain an eligible vertical interest or an eligible horizontal residual interest (including an eligible horizontal cash reserve account), or combination thereof under § __.4, with respect to a securitization transaction may offset the amount of its risk retention requirements under § __.4 by the amount of the eligible interests, respectively, acquired by an originator of one or more of the securitized assets if:

(1) At the closing of the securitization transaction:

(i) The originator acquires the eligible interest from the sponsor and retains such interest in the same manner and proportion (as between horizontal and vertical interests) as the sponsor under § __.4, as such interest was held prior to the acquisition by the originator;

(ii) The ratio of the percentage of eligible interests acquired and retained by the originator to the percentage of eligible interests otherwise required to be retained by the sponsor pursuant to § __.4, does not exceed the ratio of:

(A) The unpaid principal balance of all the securitized assets originated by the originator; to

(B) The unpaid principal balance of all the securitized assets in the securitization transaction;

(iii) The originator acquires and retains at least 20 percent of the aggregate risk retention amount otherwise required to be retained by the sponsor pursuant to § __.4; and

(iv) The originator purchases the eligible interests from the sponsor at a price that is equal, on a dollar-for-dollar basis, to the amount by which the sponsor's required risk retention is reduced in accordance with this section, by payment to the sponsor in the form of:

(A) Cash; or

(B) A reduction in the price received by the originator from the sponsor or depositor for the assets sold by the originator to the sponsor or depositor for inclusion in the pool of securitized assets.

(2) *Disclosures.* In addition to the disclosures required pursuant to § __.4(c), the sponsor provides, or causes to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities as part of the securitization transaction and, upon request, to the Commission and its appropriate Federal banking agency, if any, in written form under the caption ''Credit Risk Retention'', the name and form of organization of any originator that will acquire and retain (or has acquired and retained) an interest in the transaction pursuant to this section, including a description of the form and amount (expressed as a percentage and dollar amount (or corresponding amount in the foreign currency in which the ABS interests are issued, as applicable)) and nature (*e.g.,* senior or subordinated) of the interest, as well as the method of payment for such interest under paragraph (a)(1)(iv) of this section.

(3) *Hedging, transferring and pledging.* The originator and each of its affiliates complies with the hedging and other restrictions in § __.12 with respect to the interests retained by the originator pursuant to this section as if it were the retaining sponsor and was required to retain the interest under subpart B of this part.

(b) *Duty to comply.* (1) The retaining sponsor shall be responsible for compliance with this section.

(2) A retaining sponsor relying on this section:

(i) Shall maintain and adhere to policies and procedures that are reasonably designed to monitor the compliance by each originator that is allocated a portion of the sponsor's risk retention obligations with the requirements in paragraphs (a)(1) and (3) of this section; and

(ii) In the event the sponsor determines that any such originator no longer complies with any of the requirements in paragraphs (a)(1) and (3) of this section, shall promptly notify, or cause to be notified, the holders of the ABS interests issued in the

securitization transaction of such noncompliance by such originator.

§ __.12 Hedging, transfer and financing prohibitions.

(a) *Transfer.* Except as permitted by § __.7(b)(8), and subject to § __.5, a retaining sponsor may not sell or otherwise transfer any interest or assets that the sponsor is required to retain pursuant to subpart B of this part to any person other than an entity that is and remains a majority-owned affiliate of the sponsor and each such majority-owned affiliate shall be subject to the same restrictions.

(b) *Prohibited hedging by sponsor and affiliates.* A retaining sponsor and its affiliates may not purchase or sell a security, or other financial instrument, or enter into an agreement, derivative or other position, with any other person if:

(1) Payments on the security or other financial instrument or under the agreement, derivative, or position are materially related to the credit risk of one or more particular ABS interests that the retaining sponsor (or any of its majority-owned affiliates) is required to retain with respect to a securitization transaction pursuant to subpart B of this part or one or more of the particular securitized assets that collateralize the asset-backed securities issued in the securitization transaction; and

(2) The security, instrument, agreement, derivative, or position in any way reduces or limits the financial exposure of the sponsor (or any of its majority-owned affiliates) to the credit risk of one or more of the particular ABS interests that the retaining sponsor (or any of its majority-owned affiliates) is required to retain with respect to a securitization transaction pursuant to subpart B of this part or one or more of the particular securitized assets that collateralize the asset-backed securities issued in the securitization transaction.

(c) *Prohibited hedging by issuing entity.* The issuing entity in a securitization transaction may not purchase or sell a security or other financial instrument, or enter into an agreement, derivative or position, with any other person if:

(1) Payments on the security or other financial instrument or under the agreement, derivative or position are materially related to the credit risk of one or more particular ABS interests that the retaining sponsor for the transaction (or any of its majority-owned affiliates) is required to retain with respect to the securitization transaction pursuant to subpart B of this part; and

(2) The security, instrument, agreement, derivative, or position in any way reduces or limits the financial exposure of the retaining sponsor (or any of its majority-owned affiliates) to the credit risk of one or more of the particular ABS interests that the sponsor (or any of its majority-owned affiliates) is required to retain pursuant to subpart B of this part.

(d) *Permitted hedging activities.* The following activities shall not be considered prohibited hedging activities under paragraph (b) or (c) of this section:

(1) Hedging the interest rate risk (which does not include the specific interest rate risk, known as spread risk, associated with the ABS interest that is otherwise considered part of the credit risk) or foreign exchange risk arising from one or more of the particular ABS interests required to be retained by the sponsor (or any of its majority-owned affiliates) under subpart B of this part or one or more of the particular securitized assets that underlie the asset-backed securities issued in the securitization transaction; or

(2) Purchasing or selling a security or other financial instrument or entering into an agreement, derivative, or other position with any third party where payments on the security or other financial instrument or under the agreement, derivative, or position are based, directly or indirectly, on an index of instruments that includes asset-backed securities if:

(i) Any class of ABS interests in the issuing entity that were issued in connection with the securitization transaction and that are included in the index represents no more than 10 percent of the dollar-weighted average (or corresponding weighted average in the currency in which the ABS interests are issued, as applicable) of all instruments included in the index; and

(ii) All classes of ABS interests in all issuing entities that were issued in connection with any securitization transaction in which the sponsor (or any of its majority-owned affiliates) is required to retain an interest pursuant to subpart B of this part and that are included in the index represent, in the aggregate, no more than 20 percent of the dollar-weighted average (or corresponding weighted average in the currency in which the ABS interests are issued, as applicable) of all instruments included in the index.

(e) *Prohibited non-recourse financing.* Neither a retaining sponsor nor any of its affiliates may pledge as collateral for any obligation (including a loan, repurchase agreement, or other financing transaction) any ABS interest that the sponsor is required to retain with respect to a securitization transaction pursuant to subpart B of this part unless such obligation is with full recourse to the sponsor or affiliate, respectively.

(f) *Duration of the hedging and transfer restrictions*—(1) *General rule.* Except as provided in paragraph (f)(2) of this section, the prohibitions on sale and hedging pursuant to paragraphs (a) and (b) of this section shall expire on or after the date that is the latest of:

(i) The date on which the total unpaid principal balance (if applicable) of the securitized assets that collateralize the securitization transaction has been reduced to 33 percent of the total unpaid principal balance of the securitized assets as of the cut-off date or similar date for establishing the composition of the securitized assets collateralizing the asset-backed securities issued pursuant to the securitization transaction;

(ii) The date on which the total unpaid principal obligations under the ABS interests issued in the securitization transaction has been reduced to 33 percent of the total unpaid principal obligations of the ABS interests at closing of the securitization transaction; or

(iii) Two years after the date of the closing of the securitization transaction.

(2) *Securitizations of residential mortgages.* (i) If all of the assets that collateralize a securitization transaction subject to risk retention under this part are residential mortgages, the prohibitions on sale and hedging pursuant to paragraphs (a) and (b) of this section shall expire on or after the date that is the later of:

(A) Five years after the date of the closing of the securitization transaction; or

(B) The date on which the total unpaid principal balance of the residential mortgages that collateralize the securitization transaction has been reduced to 25 percent of the total unpaid principal balance of such residential mortgages at the cut-off date or similar date for establishing the composition of the securitized assets collateralizing the asset-backed securities issued pursuant to the securitization transaction.

(ii) Notwithstanding paragraph (f)(2)(i) of this section, the prohibitions on sale and hedging pursuant to paragraphs (a) and (b) of this section shall expire with respect to the sponsor of a securitization transaction described in paragraph (f)(2)(i) of this section on or after the date that is seven years after the date of the closing of the securitization transaction.

(3) *Conservatorship or receivership of sponsor.* A conservator or receiver of the

sponsor (or any other person holding risk retention pursuant to this part) of a securitization transaction is permitted to sell or hedge any economic interest in the securitization transaction if the conservator or receiver has been appointed pursuant to any provision of federal or State law (or regulation promulgated thereunder) that provides for the appointment of the Federal Deposit Insurance Corporation, or an agency or instrumentality of the United States or of a State as conservator or receiver, including without limitation any of the following authorities:

(i) 12 U.S.C. 1811;

(ii) 12 U.S.C. 1787;

(iii) 12 U.S.C. 4617; or

(iv) 12 U.S.C. 5382.

(4) *Revolving pool securitizations.* The provisions of paragraphs (f)(1) and (2) are not available to sponsors of revolving pool securitizations with respect to the forms of risk retention specified in § __.5.

Subpart D—Exceptions and Exemptions

§ __.13 Exemption for qualified residential mortgages.

(a) *Definitions.* For purposes of this section, the following definitions shall apply:

Currently performing means the borrower in the mortgage transaction is not currently thirty (30) days or more past due, in whole or in part, on the mortgage transaction.

Qualified residential mortgage means a ''qualified mortgage'' as defined in section 129C of the Truth in Lending Act (15 U.S.C.1639c) and regulations issued thereunder, as amended from time to time.

(b) *Exemption.* A sponsor shall be exempt from the risk retention requirements in subpart B of this part with respect to any securitization transaction, if:

(1) All of the assets that collateralize the asset-backed securities are qualified residential mortgages or servicing assets;

(2) None of the assets that collateralize the asset-backed securities are asset-backed securities;

(3) As of the cut-off date or similar date for establishing the composition of the securitized assets collateralizing the asset-backed securities issued pursuant to the securitization transaction, each qualified residential mortgage collateralizing the asset-backed securities is currently performing; and

(4)(i) The depositor with respect to the securitization transaction certifies that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the asset-backed security are qualified residential mortgages or servicing assets and has concluded that its internal supervisory controls are effective; and

(ii) The evaluation of the effectiveness of the depositor's internal supervisory controls must be performed, for each issuance of an asset-backed security in reliance on this section, as of a date within 60 days of the cut-off date or similar date for establishing the composition of the asset pool collateralizing such asset-backed security; and

(iii) The sponsor provides, or causes to be provided, a copy of the certification described in paragraph (b)(4)(i) of this section to potential investors a reasonable period of time prior to the sale of asset-backed securities in the issuing entity, and, upon request, to the Commission and its appropriate Federal banking agency, if any.

(c) *Repurchase of loans subsequently determined to be non-qualified after closing.* A sponsor that has relied on the exemption provided in paragraph (b) of this section with respect to a securitization transaction shall not lose such exemption with respect to such transaction if, after closing of the securitization transaction, it is determined that one or more of the residential mortgage loans collateralizing the asset-backed securities does not meet all of the criteria to be a qualified residential mortgage *provided that:*

(1) The depositor complied with the certification requirement set forth in paragraph (b)(4) of this section;

(2) The sponsor repurchases the loan(s) from the issuing entity at a price at least equal to the remaining aggregate unpaid principal balance and accrued interest on the loan(s) no later than 90 days after the determination that the loans do not satisfy the requirements to be a qualified residential mortgage; and

(3) The sponsor promptly notifies, or causes to be notified, the holders of the asset-backed securities issued in the securitization transaction of any loan(s) included in such securitization transaction that is (or are) required to be repurchased by the sponsor pursuant to paragraph (c)(2) of this section, including the amount of such repurchased loan(s) and the cause for such repurchase.

§ __.14 Definitions applicable to qualifying commercial loans, qualifying commercial real estate loans, and qualifying automobile loans.

The following definitions apply for purposes of §§ __.15 through __.18:

Appraisal Standards Board means the board of the Appraisal Foundation that develops, interprets, and amends the Uniform Standards of Professional Appraisal Practice (USPAP), establishing generally accepted standards for the appraisal profession.

Automobile loan:

(1) Means any loan to an individual to finance the purchase of, and that is secured by a first lien on, a passenger car or other passenger vehicle, such as a minivan, van, sport-utility vehicle, pickup truck, or similar light truck for personal, family, or household use; and

(2) Does not include any:

(i) Loan to finance fleet sales;

(ii) Personal cash loan secured by a previously purchased automobile;

(iii) Loan to finance the purchase of a commercial vehicle or farm equipment that is not used for personal, family, or household purposes;

(iv) Lease financing;

(v) Loan to finance the purchase of a vehicle with a salvage title; or

(vi) Loan to finance the purchase of a vehicle intended to be used for scrap or parts.

Combined loan-to-value (CLTV) ratio means, at the time of origination, the sum of the principal balance of a first-lien mortgage loan on the property, plus the principal balance of any junior-lien mortgage loan that, to the creditor's knowledge, would exist at the closing of the transaction and that is secured by the same property, divided by:

(1) For acquisition funding, the lesser of the purchase price or the estimated market value of the real property based on an appraisal that meets the requirements set forth in § __.17(a)(2)(ii); or

(2) For refinancing, the estimated market value of the real property based on an appraisal that meets the requirements set forth in § __.17(a)(2)(ii).

Commercial loan means a secured or unsecured loan to a company or an individual for business purposes, other than any:

(1) Loan to purchase or refinance a one-to-four family residential property;

(2) Commercial real estate loan.

Commercial real estate (CRE) loan means:

(1) A loan secured by a property with five or more single family units, or by nonfarm nonresidential real property, the primary source (50 percent or more) of repayment for which is expected to be:

(i) The proceeds of the sale, refinancing, or permanent financing of the property; or

(ii) Rental income associated with the property;

(2) Loans secured by improved land if the obligor owns the fee interest in the land and the land is leased to a third party who owns all improvements on the land, and the improvements are nonresidential or residential with five or more single family units; and

(3) Does not include:

(i) A land development and construction loan (including 1- to 4-family residential or commercial construction loans);

(ii) Any other land loan; or

(iii) An unsecured loan to a developer.

Debt service coverage (DSC) ratio means:

(1) For qualifying leased CRE loans, qualifying multi-family loans, and other CRE loans:

(i) The annual NOI less the annual replacement reserve of the CRE property at the time of origination of the CRE loan(s) divided by

(ii) The sum of the borrower's annual payments for principal and interest (calculated at the fully-indexed rate) on any debt obligation.

(2) For commercial loans:

(i) The borrower's EBITDA as of the most recently completed fiscal year divided by

(ii) The sum of the borrower's annual payments for principal and interest on all debt obligations.

Debt to income (DTI) ratio means the borrower's total debt, including the monthly amount due on the automobile loan, divided by the borrower's monthly income.

Earnings before interest, taxes, depreciation, and amortization (EBITDA) means the annual income of a business before expenses for interest, taxes, depreciation and amortization are deducted, as determined in accordance with GAAP.

Environmental risk assessment means a process for determining whether a property is contaminated or exposed to any condition or substance that could result in contamination that has an adverse effect on the market value of the property or the realization of the collateral value.

First lien means a lien or encumbrance on property that has priority over all other liens or encumbrances on the property.

Junior lien means a lien or encumbrance on property that is lower in priority relative to other liens or encumbrances on the property.

Leverage ratio means the borrower's total debt divided by the borrower's EBITDA.

Loan-to-value (LTV) ratio means, at the time of origination, the principal balance of a first-lien mortgage loan on the property divided by:

(1) For acquisition funding, the lesser of the purchase price or the estimated market value of the real property based on an appraisal that meets the requirements set forth in § __.17(a)(2)(ii); or

(2) For refinancing, the estimated market value of the real property based on an appraisal that meets the requirements set forth in § __.17(a)(2)(ii).

Model year means the year determined by the manufacturer and reflected on the vehicle's Motor Vehicle Title as part of the vehicle description.

Net operating income (NOI) refers to the income a CRE property generates for the owner after all expenses have been deducted for federal income tax purposes, except for depreciation, debt service expenses, and federal and state income taxes, and excluding any unusual and nonrecurring items of income.

Operating affiliate means an affiliate of a borrower that is a lessor or similar party with respect to the commercial real estate securing the loan.

Payments-in-kind means payments of accrued interest that are not paid in cash when due, and instead are paid by increasing the principal balance of the loan or by providing equity in the borrowing company.

Purchase money security interest means a security interest in property that secures the obligation of the obligor incurred as all or part of the price of the property.

Purchase price means the amount paid by the borrower for the vehicle net of any incentive payments or manufacturer cash rebates.

Qualified tenant means:

(1) A tenant with a lease who has satisfied all obligations with respect to the property in a timely manner; or

(2) A tenant who originally had a lease that subsequently expired and currently is leasing the property on a month-to-month basis, has occupied the property for at least three years prior to the date of origination, and has satisfied all obligations with respect to the property in a timely manner.

Qualifying leased CRE loan means a CRE loan secured by commercial nonfarm real property, other than a multi-family property or a hotel, inn, or similar property:

(1) That is occupied by one or more qualified tenants pursuant to a lease agreement with a term of no less than one (1) month; and

(2) Where no more than 20 percent of the aggregate gross revenue of the property is payable from one or more tenants who:

(i) Are subject to a lease that will terminate within six months following the date of origination; or

(ii) Are not qualified tenants.

Qualifying multi-family loan means a CRE loan secured by any residential property (excluding a hotel, motel, inn, hospital, nursing home, or other similar facility where dwellings are not leased to residents):

(1) That consists of five or more dwelling units (including apartment buildings, condominiums, cooperatives and other similar structures) primarily for residential use; and

(2) Where at least 75 percent of the NOI is derived from residential rents and tenant amenities (including income from parking garages, health or swim clubs, and dry cleaning), and not from other commercial uses.

Rental income means:

(1) Income derived from a lease or other occupancy agreement between the borrower or an operating affiliate of the borrower and a party which is not an affiliate of the borrower for the use of real property or improvements serving as collateral for the applicable loan; and

(2) Other income derived from hotel, motel, dormitory, nursing home, assisted living, mini-storage warehouse or similar properties that are used primarily by parties that are not affiliates or employees of the borrower or its affiliates.

Replacement reserve means the monthly capital replacement or maintenance amount based on the property type, age, construction and condition of the property that is adequate to maintain the physical condition and NOI of the property.

Salvage title means a form of vehicle title branding, which notes that the vehicle has been severely damaged and/or deemed a total loss and uneconomical to repair by an insurance company that paid a claim on the vehicle.

Total debt, with respect to a borrower, means:

(1) In the case of an automobile loan, the sum of:

(i) All monthly housing payments (rent- or mortgage-related, including property taxes, insurance and home owners association fees); and

(ii) Any of the following that is dependent upon the borrower's income for payment:

(A) Monthly payments on other debt and lease obligations, such as credit card loans or installment loans, including the monthly amount due on the automobile loan;

(B) Estimated monthly amortizing payments for any term debt, debts with other than monthly payments and debts

not in repayment (such as deferred student loans, interest-only loans); and

(C) Any required monthly alimony, child support or court-ordered payments; and

(2) In the case of a commercial loan, the outstanding balance of all long-term debt (obligations that have a remaining maturity of more than one year) and the current portion of all debt that matures in one year or less.

Total liabilities ratio means the borrower's total liabilities divided by the sum of the borrower's total liabilities and equity, less the borrower's intangible assets, with each component determined in accordance with GAAP.

Trade-in allowance means the amount a vehicle purchaser is given as a credit at the purchase of a vehicle for the fair exchange of the borrower's existing vehicle to compensate the dealer for some portion of the vehicle purchase price, not to exceed the highest trade-in value of the existing vehicle, as determined by a nationally recognized automobile pricing agency and based on the manufacturer, year, model, features, mileage, and condition of the vehicle, less the payoff balance of any outstanding debt collateralized by the existing vehicle.

Uniform Standards of Professional Appraisal Practice (USPAP) means generally accepted standards for professional appraisal practice issued by the Appraisal Standards Board of the Appraisal Foundation.

§ __.15 Qualifying commercial loans, commercial real estate loans, and automobile loans.

(a) *General exception for qualifying assets.* Commercial loans, commercial real estate loans, and automobile loans that are securitized through a securitization transaction shall be subject to a 0 percent risk retention requirement under subpart B, provided that the following conditions are met:

(1) The assets meet the underwriting standards set forth in §§ __.16 (qualifying commercial loans), __.17 (qualifying CRE loans), or __.18 (qualifying automobile loans) of this part, as applicable;

(2) The securitization transaction is collateralized solely by loans of the same asset class and by servicing assets;

(3) The securitization transaction does not permit reinvestment periods; and

(4) The sponsor provides, or causes to be provided, to potential investors a reasonable period of time prior to the sale of asset-backed securities of the issuing entity, and, upon request, to the Commission, and to its appropriate Federal banking agency, if any, in written form under the caption ''Credit Risk Retention'', a description of the manner in which the sponsor determined the aggregate risk retention requirement for the securitization transaction after including qualifying commercial loans, qualifying CRE loans, or qualifying automobile loans with 0 percent risk retention.

(b) *Risk retention requirement.* For any securitization transaction described in paragraph (a) of this section, the percentage of risk retention required under § __.3(a) is reduced by the percentage evidenced by the ratio of the unpaid principal balance of the qualifying commercial loans, qualifying CRE loans, or qualifying automobile loans (as applicable) to the total unpaid principal balance of commercial loans, CRE loans, or automobile loans (as applicable) that are included in the pool of assets collateralizing the asset-backed securities issued pursuant to the securitization transaction (the qualifying asset ratio); provided that:

(1) The qualifying asset ratio is measured as of the cut-off date or similar date for establishing the composition of the securitized assets collateralizing the asset-backed securities issued pursuant to the securitization transaction;

(2) If the qualifying asset ratio would exceed 50 percent, the qualifying asset ratio shall be deemed to be 50 percent; and

(3) The disclosure required by paragraph (a)(4) of this section also includes descriptions of the qualifying commercial loans, qualifying CRE loans, and qualifying automobile loans (qualifying assets) and descriptions of the assets that are not qualifying assets, and the material differences between the group of qualifying assets and the group of assets that are not qualifying assets with respect to the composition of each group's loan balances, loan terms, interest rates, borrower credit information, and characteristics of any loan collateral.

(c) *Exception for securitizations of qualifying assets only.* Notwithstanding other provisions of this section, the risk retention requirements of subpart B of this part shall not apply to securitization transactions where the transaction is collateralized solely by servicing assets and either qualifying commercial loans, qualifying CRE loans, or qualifying automobile loans.

(d) *Record maintenance.* A sponsor must retain the disclosures required in paragraphs (a) and (b) of this section and the certifications required in §§ __.16(a)(8), __.17(a)(10), and __.18(a)(8), as applicable, in its records until three years after all ABS interests issued in the securitization are no longer outstanding. The sponsor must provide the disclosures and certifications upon request to the Commission and the sponsor's appropriate Federal banking agency, if any.

§ __.16 Underwriting standards for qualifying commercial loans.

(a) *Underwriting, product and other standards.* (1) Prior to origination of the commercial loan, the originator:

(i) Verified and documented the financial condition of the borrower:

(A) As of the end of the borrower's two most recently completed fiscal years; and

(B) During the period, if any, since the end of its most recently completed fiscal year;

(ii) Conducted an analysis of the borrower's ability to service its overall debt obligations during the next two years, based on reasonable projections;

(iii) Determined that, based on the previous two years' actual performance, the borrower had:

(A) A total liabilities ratio of 50 percent or less;

(B) A leverage ratio of 3.0 or less; and

(C) A DSC ratio of 1.5 or greater;

(iv) Determined that, based on the two years of projections, which include the new debt obligation, following the closing date of the loan, the borrower will have:

(A) A total liabilities ratio of 50 percent or less;

(B) A leverage ratio of 3.0 or less; and

(C) A DSC ratio of 1.5 or greater.

(2) Prior to, upon or promptly following the inception of the loan, the originator:

(i) If the loan is originated on a secured basis, obtains a perfected security interest (by filing, title notation or otherwise) or, in the case of real property, a recorded lien, on all of the property pledged to collateralize the loan; and

(ii) If the loan documents indicate the purpose of the loan is to finance the purchase of tangible or intangible property, or to refinance such a loan, obtains a first lien on the property.

(3) The loan documentation for the commercial loan includes covenants that:

(i) Require the borrower to provide to the servicer of the commercial loan the borrower's financial statements and supporting schedules on an ongoing basis, but not less frequently than quarterly;

(ii) Prohibit the borrower from retaining or entering into a debt arrangement that permits payments-in-kind;

(iii) Impose limits on:

(A) The creation or existence of any other security interest or lien with respect to any of the borrower's property that serves as collateral for the loan;

(B) The transfer of any of the borrower's assets that serve as collateral for the loan; and

(C) Any change to the name, location or organizational structure of the borrower, or any other party that pledges collateral for the loan;

(iv) Require the borrower and any other party that pledges collateral for the loan to:

(A) Maintain insurance that protects against loss on the collateral for the commercial loan at least up to the amount of the loan, and that names the originator or any subsequent holder of the loan as an additional insured or loss payee;

(B) Pay taxes, charges, fees, and claims, where non-payment might give rise to a lien on any collateral;

(C) Take any action required to perfect or protect the security interest and first lien (as applicable) of the originator or any subsequent holder of the loan in any collateral for the commercial loan or the priority thereof, and to defend any collateral against claims adverse to the lender's interest;

(D) Permit the originator or any subsequent holder of the loan, and the servicer of the loan, to inspect any collateral for the commercial loan and the books and records of the borrower; and

(E) Maintain the physical condition of any collateral for the commercial loan.

(4) Loan payments required under the loan agreement are:

(i) Based on level monthly payments of principal and interest (at the fully indexed rate) that fully amortize the debt over a term that does not exceed five years from the date of origination; and

(ii) To be made no less frequently than quarterly over a term that does not exceed five years.

(5) The primary source of repayment for the loan is revenue from the business operations of the borrower.

(6) The loan was funded within the six (6) months prior to the cut-off date or similar date for establishing the composition of the securitized assets collateralizing the asset-backed securities issued pursuant to the securitization transaction.

(7) At the cut-off date or similar date for establishing the composition of the securitized assets collateralizing the asset-backed securities issued pursuant to the securitization transaction, all payments due on the loan are contractually current.

(8)(i) The depositor of the asset-backed security certifies that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all qualifying commercial loans that collateralize the asset-backed security and that reduce the sponsor's risk retention requirement under § __.15 meet all of the requirements set forth in paragraphs (a)(1) through (7) of this section and has concluded that its internal supervisory controls are effective;

(ii) The evaluation of the effectiveness of the depositor's internal supervisory controls referenced in paragraph (a)(8)(i) of this section shall be performed, for each issuance of an asset-backed security, as of a date within 60 days of the cut-off date or similar date for establishing the composition of the asset pool collateralizing such asset-backed security; and

(iii) The sponsor provides, or causes to be provided, a copy of the certification described in paragraph (a)(8)(i) of this section to potential investors a reasonable period of time prior to the sale of asset-backed securities in the issuing entity, and, upon request, to its appropriate Federal banking agency, if any.

(b) *Cure or buy-back requirement.* If a sponsor has relied on the exception provided in § __.15 with respect to a qualifying commercial loan and it is subsequently determined that the loan did not meet all of the requirements set forth in paragraphs (a)(1) through (7) of this section, the sponsor shall not lose the benefit of the exception with respect to the commercial loan if the depositor complied with the certification requirement set forth in paragraph (a)(8) of this section and:

(1) The failure of the loan to meet any of the requirements set forth in paragraphs (a)(1) through (7) of this section is not material; or

(2) No later than 90 days after the determination that the loan does not meet one or more of the requirements of paragraphs (a)(1) through (7) of this section, the sponsor:

(i) Effectuates cure, establishing conformity of the loan to the unmet requirements as of the date of cure; or

(ii) Repurchases the loan(s) from the issuing entity at a price at least equal to the remaining principal balance and accrued interest on the loan(s) as of the date of repurchase.

(3) If the sponsor cures or repurchases pursuant to paragraph (b)(2) of this section, the sponsor must promptly notify, or cause to be notified, the holders of the asset-backed securities issued in the securitization transaction of any loan(s) included in such securitization transaction that is required to be cured or repurchased by the sponsor pursuant to paragraph (b)(2) of this section, including the principal amount of such loan(s) and the cause for such cure or repurchase.

§ __.17 Underwriting standards for qualifying CRE loans.

(a) *Underwriting, product and other standards.* (1) The CRE loan must be secured by the following:

(i) An enforceable first lien, documented and recorded appropriately pursuant to applicable law, on the commercial real estate and improvements;

(ii)(A) An assignment of:

(*1*) Leases and rents and other occupancy agreements related to the commercial real estate or improvements or the operation thereof for which the borrower or an operating affiliate is a lessor or similar party and all payments under such leases and occupancy agreements; and

(*2*) All franchise, license and concession agreements related to the commercial real estate or improvements or the operation thereof for which the borrower or an operating affiliate is a lessor, licensor, concession granter or similar party and all payments under such other agreements, whether the assignments described in this paragraph (a)(1)(ii)(A)(*2*) are absolute or are stated to be made to the extent permitted by the agreements governing the applicable franchise, license or concession agreements;

(B) An assignment of all other payments due to the borrower or due to any operating affiliate in connection with the operation of the property described in paragraph (a)(1)(i) of this section; and

(C) The right to enforce the agreements described in paragraph (a)(1)(ii)(A) of this section and the agreements under which payments under paragraph (a)(1)(ii)(B) of this section are due against, and collect amounts due from, each lessee, occupant or other obligor whose payments were assigned pursuant to paragraphs (a)(1)(ii)(A) or (B) of this section upon a breach by the borrower of any of the terms of, or the occurrence of any other event of default (however denominated) under, the loan documents relating to such CRE loan; and

(iii) A security interest:

(A) In all interests of the borrower and any applicable operating affiliate in all tangible and intangible personal property of any kind, in or used in the operation of or in connection with,

pertaining to, arising from, or constituting, any of the collateral described in paragraphs (a)(1)(i) or (ii) of this section; and

(B) In the form of a perfected security interest if the security interest in such property can be perfected by the filing of a financing statement, fixture filing, or similar document pursuant to the law governing the perfection of such security interest;

(2) Prior to origination of the CRE loan, the originator:

(i) Verified and documented the current financial condition of the borrower and each operating affiliate;

(ii) Obtained a written appraisal of the real property securing the loan that:

(A) Had an effective date not more than six months prior to the origination date of the loan by a competent and appropriately State-certified or State-licensed appraiser;

(B) Conforms to generally accepted appraisal standards as evidenced by the USPAP and the appraisal requirements [1] of the Federal banking agencies; and

(C) Provides an ''as is'' opinion of the market value of the real property, which includes an income approach; [2]

(iii) Qualified the borrower for the CRE loan based on a monthly payment amount derived from level monthly payments consisting of both principal and interest (at the fully-indexed rate) over the term of the loan, not exceeding 25 years, or 30 years for a qualifying multi-family property;

(iv) Conducted an environmental risk assessment to gain environmental information about the property securing the loan and took appropriate steps to mitigate any environmental liability determined to exist based on this assessment;

(v) Conducted an analysis of the borrower's ability to service its overall debt obligations during the next two years, based on reasonable projections (including operating income projections for the property);

(vi)(A) Determined that based on the two years' actual performance immediately preceding the origination of the loan, the borrower would have had:

(*1*) A DSC ratio of 1.5 or greater, if the loan is a qualifying leased CRE loan, net of any income derived from a tenant(s) who is not a qualified tenant(s);

(*2*) A DSC ratio of 1.25 or greater, if the loan is a qualifying multi-family property loan; or

(*3*) A DSC ratio of 1.7 or greater, if the loan is any other type of CRE loan;

(B) If the borrower did not own the property for any part of the last two years prior to origination, the calculation of the DSC ratio, for purposes of paragraph (a)(2)(vi)(A) of this section, shall include the property's operating income for any portion of the two-year period during which the borrower did not own the property;

(vii) Determined that, based on two years of projections, which include the new debt obligation, following the origination date of the loan, the borrower will have:

(A) A DSC ratio of 1.5 or greater, if the loan is a qualifying leased CRE loan, net of any income derived from a tenant(s) who is not a qualified tenant(s);

(B) A DSC ratio of 1.25 or greater, if the loan is a qualifying multi-family property loan; or

(C) A DSC ratio of 1.7 or greater, if the loan is any other type of CRE loan.

(3) The loan documentation for the CRE loan includes covenants that:

(i) Require the borrower to provide the borrower's financial statements and supporting schedules to the servicer on an ongoing basis, but not less frequently than quarterly, including information on existing, maturing and new leasing or rent-roll activity for the property securing the loan, as appropriate; and

(ii) Impose prohibitions on:

(A) The creation or existence of any other security interest with respect to the collateral for the CRE loan described in paragraphs (a)(1)(i) and (a)(1)(ii)(A) of this section, except as provided in paragraph (a)(4) of this section;

(B) The transfer of any collateral for the CRE loan described in paragraph (a)(1)(i) or (a)(1)(ii)(A) of this section or of any other collateral consisting of fixtures, furniture, furnishings, machinery or equipment other than any such fixture, furniture, furnishings, machinery or equipment that is obsolete or surplus; and

(C) Any change to the name, location or organizational structure of any borrower, operating affiliate or other pledgor unless such borrower, operating affiliate or other pledgor shall have given the holder of the loan at least 30 days advance notice and, pursuant to applicable law governing perfection and priority, the holder of the loan is able to take all steps necessary to continue its perfection and priority during such 30-day period.

(iii) Require each borrower and each operating affiliate to:

(A) Maintain insurance that protects against loss on collateral for the CRE loan described in paragraph (a)(1)(i) of this section for an amount no less than the replacement cost of the property improvements, and names the originator or any subsequent holder of the loan as an additional insured or lender loss payee;

(B) Pay taxes, charges, fees, and claims, where non-payment might give rise to a lien on collateral for the CRE loan described in paragraphs (a)(1)(i) and (ii) of this section;

(C) Take any action required to:

(*1*) Protect the security interest and the enforceability and priority thereof in the collateral described in paragraphs (a)(1)(i) and (a)(1)(ii)(A) of this section and defend such collateral against claims adverse to the originator's or any subsequent holder's interest; and

(*2*) Perfect the security interest of the originator or any subsequent holder of the loan in any other collateral for the CRE loan to the extent that such security interest is required by this section to be perfected;

(D) Permit the originator or any subsequent holder of the loan, and the servicer, to inspect any collateral for the CRE loan and the books and records of the borrower or other party relating to any collateral for the CRE loan;

(E) Maintain the physical condition of collateral for the CRE loan described in paragraph (a)(1)(i) of this section;

(F) Comply with all environmental, zoning, building code, licensing and other laws, regulations, agreements, covenants, use restrictions, and proffers applicable to collateral for the CRE loan described in paragraph (a)(1)(i) of this section;

(G) Comply with leases, franchise agreements, condominium declarations, and other documents and agreements relating to the operation of collateral for the CRE loan described in paragraph (a)(1)(i) of this section, and to not modify any material terms and conditions of such agreements over the term of the loan without the consent of the originator or any subsequent holder of the loan, or the servicer; and

(H) Not materially alter collateral for the CRE loan described in paragraph (a)(1)(i) of this section without the consent of the originator or any subsequent holder of the loan, or the servicer.

(4) The loan documentation for the CRE loan prohibits the borrower and each operating affiliate from obtaining a loan secured by a junior lien on collateral for the CRE loan described in paragraph (a)(1)(i) or (a)(1)(ii)(A) of this section, unless:

(i) The sum of the principal amount of such junior lien loan, plus the principal amount of all other loans secured by collateral described in paragraph (a)(1)(i) or (a)(1)(ii)(A) of this section, does not exceed the applicable CLTV ratio in paragraph (a)(5) of this

[1] 12 CFR part 34, subpart C (OCC); 12 CFR part 208, subpart E, and 12 CFR part 225, subpart G (Board); and 12 CFR part 323 (FDIC).

[2] See USPAP, Standard 1.

section, based on the appraisal at origination of such junior lien loan; or

(ii) Such loan is a purchase money obligation that financed the acquisition of machinery or equipment and the borrower or operating affiliate (as applicable) pledges such machinery and equipment as additional collateral for the CRE loan.

(5) At origination, the applicable loan-to-value ratios for the loan are:

(i) LTV less than or equal to 65 percent and CLTV less than or equal to 70 percent; or

(ii) LTV less than or equal to 60 percent and CLTV less than or equal to 65 percent, if an appraisal used to meet the requirements set forth in paragraph (a)(2)(ii) of this section used a direct capitalization rate, and that rate is less than or equal to the sum of:

(A) The 10-year swap rate, as reported in the Federal Reserve's H.15 Report (or any successor report) as of the date concurrent with the effective date of such appraisal; and

(B) 300 basis points.

(iii) If the appraisal required under paragraph (a)(2)(ii) of this section included a direct capitalization method using an overall capitalization rate, that rate must be disclosed to potential investors in the securitization.

(6) All loan payments required to be made under the loan agreement are:

(i) Based on level monthly payments of principal and interest (at the fully indexed rate) to fully amortize the debt over a term that does not exceed 25 years, or 30 years for a qualifying multifamily loan; and

(ii) To be made no less frequently than monthly over a term of at least ten years.

(7) Under the terms of the loan agreement:

(i) Any maturity of the note occurs no earlier than ten years following the date of origination;

(ii) The borrower is not permitted to defer repayment of principal or payment of interest; and

(iii) The interest rate on the loan is:

(A) A fixed interest rate;

(B) An adjustable interest rate and the borrower, prior to or concurrently with origination of the CRE loan, obtained a derivative that effectively results in a fixed interest rate; or

(C) An adjustable interest rate and the borrower, prior to or concurrently with origination of the CRE loan, obtained a derivative that established a cap on the interest rate for the term of the loan, and the loan meets the underwriting criteria in paragraphs (a)(2)(vi) and (vii) of this section using the maximum interest rate allowable under the interest rate cap.

(8) The originator does not establish an interest reserve at origination to fund all or part of a payment on the loan.

(9) At the cut-off date or similar date for establishing the composition of the securitized assets collateralizing the asset-backed securities issued pursuant to the securitization transaction, all payments due on the loan are contractually current.

(10)(i) The depositor of the asset-backed security certifies that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all qualifying CRE loans that collateralize the asset-backed security and that reduce the sponsor's risk retention requirement under § __.15 meet all of the requirements set forth in paragraphs (a)(1) through (9) of this section and has concluded that its internal supervisory controls are effective;

(ii) The evaluation of the effectiveness of the depositor's internal supervisory controls referenced in paragraph (a)(10)(i) of this section shall be performed, for each issuance of an asset-backed security, as of a date within 60 days of the cut-off date or similar date for establishing the composition of the asset pool collateralizing such asset-backed security;

(iii) The sponsor provides, or causes to be provided, a copy of the certification described in paragraph (a)(10)(i) of this section to potential investors a reasonable period of time prior to the sale of asset-backed securities in the issuing entity, and, upon request, to its appropriate Federal banking agency, if any; and

(11) Within two weeks of the closing of the CRE loan by its originator or, if sooner, prior to the transfer of such CRE loan to the issuing entity, the originator shall have obtained a UCC lien search from the jurisdiction of organization of the borrower and each operating affiliate, that does not report, as of the time that the security interest of the originator in the property described in paragraph (a)(1)(iii) of this section was perfected, other higher priority liens of record on any property described in paragraph (a)(1)(iii) of this section, other than purchase money security interests.

(b) *Cure or buy-back requirement.* If a sponsor has relied on the exception provided in § ___.15 with respect to a qualifying CRE loan and it is subsequently determined that the CRE loan did not meet all of the requirements set forth in paragraphs (a)(1) through (9) and (a)(11) of this section, the sponsor shall not lose the benefit of the exception with respect to the CRE loan if the depositor complied with the certification requirement set forth in paragraph (a)(10) of this section, and:

(1) The failure of the loan to meet any of the requirements set forth in paragraphs (a)(1) through (9) and (a)(11) of this section is not material; or;

(2) No later than 90 days after the determination that the loan does not meet one or more of the requirements of paragraphs (a)(1) through (9) or (a)(11) of this section, the sponsor:

(i) Effectuates cure, restoring conformity of the loan to the unmet requirements as of the date of cure; or

(ii) Repurchases the loan(s) from the issuing entity at a price at least equal to the remaining principal balance and accrued interest on the loan(s) as of the date of repurchase.

(3) If the sponsor cures or repurchases pursuant to paragraph (b)(2) of this section, the sponsor must promptly notify, or cause to be notified, the holders of the asset-backed securities issued in the securitization transaction of any loan(s) included in such securitization transaction that is required to be cured or repurchased by the sponsor pursuant to paragraph (b)(2) of this section, including the principal amount of such repurchased loan(s) and the cause for such cure or repurchase.

§ __.18 Underwriting standards for qualifying automobile loans.

(a) *Underwriting, product and other standards.* (1) Prior to origination of the automobile loan, the originator:

(i) Verified and documented that within 30 days of the date of origination:

(A) The borrower was not currently 30 days or more past due, in whole or in part, on any debt obligation;

(B) Within the previous 24 months, the borrower has not been 60 days or more past due, in whole or in part, on any debt obligation;

(C) Within the previous 36 months, the borrower has not:

(*1*) Been a debtor in a proceeding commenced under Chapter 7 (Liquidation), Chapter 11 (Reorganization), Chapter 12 (Family Farmer or Family Fisherman plan), or Chapter 13 (Individual Debt Adjustment) of the U.S. Bankruptcy Code; or

(*2*) Been the subject of any federal or State judicial judgment for the collection of any unpaid debt;

(D) Within the previous 36 months, no one-to-four family property owned by the borrower has been the subject of any foreclosure, deed in lieu of foreclosure, or short sale; or

(E) Within the previous 36 months, the borrower has not had any personal property repossessed;

(ii) Determined and documented that the borrower has at least 24 months of credit history; and

(iii) Determined and documented that, upon the origination of the loan, the borrower's DTI ratio is less than or equal to 36 percent.

(A) For the purpose of making the determination under paragraph (a)(1)(iii) of this section, the originator must:

(*1*) Verify and document all income of the borrower that the originator includes in the borrower's effective monthly income (using payroll stubs, tax returns, profit and loss statements, or other similar documentation); and

(*2*) On or after the date of the borrower's written application and prior to origination, obtain a credit report regarding the borrower from a consumer reporting agency that compiles and maintain files on consumers on a nationwide basis (within the meaning of 15 U.S.C. 1681a(p)) and verify that all outstanding debts reported in the borrower's credit report are incorporated into the calculation of the borrower's DTI ratio under paragraph (a)(1)(iii) of this section;

(2) An originator will be deemed to have met the requirements of paragraph (a)(1)(i) of this section if:

(i) The originator, no more than 30 days before the closing of the loan, obtains a credit report regarding the borrower from a consumer reporting agency that compiles and maintains files on consumers on a nationwide basis (within the meaning of 15 U.S.C. 1681a(p));

(ii) Based on the information in such credit report, the borrower meets all of the requirements of paragraph (a)(1)(i) of this section, and no information in a credit report subsequently obtained by the originator before the closing of the loan contains contrary information; and

(iii) The originator obtains electronic or hard copies of the credit report.

(3) At closing of the automobile loan, the borrower makes a down payment from the borrower's personal funds and trade-in allowance, if any, that is at least equal to the sum of:

(i) The full cost of the vehicle title, tax, and registration fees;

(ii) Any dealer-imposed fees;

(iii) The full cost of any additional warranties, insurance or other products purchased in connection with the purchase of the vehicle; and

(iv) 10 percent of the vehicle purchase price.

(4) The originator records a first lien securing the loan on the purchased vehicle in accordance with State law.

(5) The terms of the loan agreement provide a maturity date for the loan that does not exceed the lesser of:

(i) Six years from the date of origination; or

(ii) 10 years minus the difference between the current model year and the vehicle's model year.

(6) The terms of the loan agreement:

(i) Specify a fixed rate of interest for the life of the loan;

(ii) Provide for a level monthly payment amount that fully amortizes the amount financed over the loan term;

(iii) Do not permit the borrower to defer repayment of principal or payment of interest; and

(iv) Require the borrower to make the first payment on the automobile loan within 45 days of the loan's contract date.

(7) At the cut-off date or similar date for establishing the composition of the securitized assets collateralizing the asset-backed securities issued pursuant to the securitization transaction, all payments due on the loan are contractually current; and

(8)(i) The depositor of the asset-backed security certifies that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all qualifying automobile loans that collateralize the asset-backed security and that reduce the sponsor's risk retention requirement under § __.15 meet all of the requirements set forth in paragraphs (a)(1) through (7) of this section and has concluded that its internal supervisory controls are effective;

(ii) The evaluation of the effectiveness of the depositor's internal supervisory controls referenced in paragraph (a)(8)(i) of this section shall be performed, for each issuance of an asset-backed security, as of a date within 60 days of the cut-off date or similar date for establishing the composition of the asset pool collateralizing such asset-backed security; and

(iii) The sponsor provides, or causes to be provided, a copy of the certification described in paragraph (a)(8)(i) of this section to potential investors a reasonable period of time prior to the sale of asset-backed securities in the issuing entity, and, upon request, to its appropriate Federal banking agency, if any.

(b) *Cure or buy-back requirement.* If a sponsor has relied on the exception provided in § ___.15 with respect to a qualifying automobile loan and it is subsequently determined that the loan did not meet all of the requirements set forth in paragraphs (a)(1) through (7) of this section, the sponsor shall not lose the benefit of the exception with respect to the automobile loan if the depositor complied with the certification requirement set forth in paragraph (a)(8) of this section, and:

(1) The failure of the loan to meet any of the requirements set forth in paragraphs (a)(1) through (7) of this section is not material; or

(2) No later than ninety (90) days after the determination that the loan does not meet one or more of the requirements of paragraphs (a)(1) through (7) of this section, the sponsor:

(i) Effectuates cure, establishing conformity of the loan to the unmet requirements as of the date of cure; or

(ii) Repurchases the loan(s) from the issuing entity at a price at least equal to the remaining principal balance and accrued interest on the loan(s) as of the date of repurchase.

(3) If the sponsor cures or repurchases pursuant to paragraph (b)(2) of this section, the sponsor must promptly notify, or cause to be notified, the holders of the asset-backed securities issued in the securitization transaction of any loan(s) included in such securitization transaction that is required to be cured or repurchased by the sponsor pursuant to paragraph (b)(2) of this section, including the principal amount of such loan(s) and the cause for such cure or repurchase.

§ __.19 General exemptions.

(a) *Definitions.* For purposes of this section, the following definitions shall apply:

Community-focused residential mortgage means a residential mortgage exempt from the definition of ''covered transaction'' under § 1026.43(a)(3)(iv) and (v) of the CFPB's Regulation Z (12 CFR 1026.43(a)).

First pay class means a class of ABS interests for which all interests in the class are entitled to the same priority of payment and that, at the time of closing of the transaction, is entitled to repayments of principal and payments of interest prior to or pro-rata with all other classes of securities collateralized by the same pool of first-lien residential mortgages, until such class has no principal or notional balance remaining.

Inverse floater means an ABS interest issued as part of a securitization transaction for which interest or other income is payable to the holder based on a rate or formula that varies inversely to a reference rate of interest.

Qualifying three-to-four unit residential mortgage loan means a mortgage loan that is:

(i) Secured by a dwelling (as defined in 12 CFR 1026.2(a)(19)) that is owner

occupied and contains three-to-four housing units;

(ii) Is deemed to be for business purposes for purposes of Regulation Z under 12 CFR part 1026, Supplement I, paragraph 3(a)(5)(i); and

(iii) Otherwise meets all of the requirements to qualify as a qualified mortgage under § 1026.43(e) and (f) of Regulation Z (12 CFR 1026.43(e) and (f)) as if the loan were a covered transaction under that section.

(b) This part shall not apply to:

(1) *U.S. Government-backed securitizations.* Any securitization transaction that:

(i) Is collateralized solely by residential, multifamily, or health care facility mortgage loan assets that are insured or guaranteed (in whole or in part) as to the payment of principal and interest by the United States or an agency of the United States, and servicing assets; or

(ii) Involves the issuance of asset-backed securities that:

(A) Are insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States; and

(B) Are collateralized solely by residential, multifamily, or health care facility mortgage loan assets or interests in such assets, and servicing assets.

(2) *Certain agricultural loan securitizations.* Any securitization transaction that is collateralized solely by loans or other assets made, insured, guaranteed, or purchased by any institution that is subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation, and servicing assets;

(3) *State and municipal securitizations.* Any asset-backed security that is a security issued or guaranteed by any State, or by any political subdivision of a State, or by any public instrumentality of a State that is exempt from the registration requirements of the Securities Act of 1933 by reason of section 3(a)(2) of that Act (15 U.S.C. 77c(a)(2)); and

(4) *Qualified scholarship funding bonds.* Any asset-backed security that meets the definition of a qualified scholarship funding bond, as set forth in section 150(d)(2) of the Internal Revenue Code of 1986 (26 U.S.C. 150(d)(2)).

(5) *Pass-through resecuritizations.* Any securitization transaction that:

(i) Is collateralized solely by servicing assets, and by asset-backed securities:

(A) For which credit risk was retained as required under subpart B of this part; or

(B) That were exempted from the credit risk retention requirements of this part pursuant to subpart D of this part;

(ii) Is structured so that it involves the issuance of only a single class of ABS interests; and

(iii) Provides for the pass-through of all principal and interest payments received on the underlying asset-backed securities (net of expenses of the issuing entity) to the holders of such class.

(6) *First-pay-class securitizations.* Any securitization transaction that:

(i) Is collateralized solely by servicing assets, and by first-pay classes of asset-backed securities collateralized by first-lien residential mortgages on properties located in any state:

(A) For which credit risk was retained as required under subpart B of this part; or

(B) That were exempted from the credit risk retention requirements of this part pursuant to subpart D of this part;

(ii) Does not provide for any ABS interest issued in the securitization transaction to share in realized principal losses other than pro rata with all other ABS interests issued in the securitization transaction based on the current unpaid principal balance of such ABS interests at the time the loss is realized;

(iii) Is structured to reallocate prepayment risk;

(iv) Does not reallocate credit risk (other than as a consequence of reallocation of prepayment risk); and

(v) Does not include any inverse floater or similarly structured ABS interest.

(7) *Seasoned loans.* (i) Any securitization transaction that is collateralized solely by servicing assets, and by seasoned loans that meet the following requirements:

(A) The loans have not been modified since origination; and

(B) None of the loans have been delinquent for 30 days or more.

(ii) For purposes of this paragraph, a *seasoned loan* means:

(A) With respect to asset-backed securities collateralized by residential mortgages, a loan that has been outstanding and performing for the longer of:

(*1*) A period of five years; or

(*2*) Until the outstanding principal balance of the loan has been reduced to 25 percent of the original principal balance.

(*3*) Notwithstanding paragraphs (b)(7)(ii)(A)(*1*) and (*2*) of this section, any residential mortgage loan that has been outstanding and performing for a period of at least seven years shall be deemed a seasoned loan.

(B) With respect to all other classes of asset-backed securities, a loan that has been outstanding and performing for the longer of:

(*1*) A period of at least two years; or

(*2*) Until the outstanding principal balance of the loan has been reduced to 33 percent of the original principal balance.

(8) *Certain public utility securitizations.* (i) Any securitization transaction where the asset-back securities issued in the transaction are secured by the intangible property right to collect charges for the recovery of specified costs and such other assets, if any, of an issuing entity that is wholly owned, directly or indirectly, by an investor owned utility company that is subject to the regulatory authority of a State public utility commission or other appropriate State agency.

(ii) For purposes of this paragraph:

(A) *Specified cost* means any cost identified by a State legislature as appropriate for recovery through securitization pursuant to specified cost recovery legislation; and

(B) *Specified cost recovery legislation* means legislation enacted by a State that:

(*1*) Authorizes the investor owned utility company to apply for, and authorizes the public utility commission or other appropriate State agency to issue, a financing order determining the amount of specified costs the utility will be allowed to recover;

(*2*) Provides that pursuant to a financing order, the utility acquires an intangible property right to charge, collect, and receive amounts necessary to provide for the full recovery of the specified costs determined to be recoverable, and assures that the charges are non-bypassable and will be paid by customers within the utility's historic service territory who receive utility goods or services through the utility's transmission and distribution system, even if those customers elect to purchase these goods or services from a third party; and

(*3*) Guarantees that neither the State nor any of its agencies has the authority to rescind or amend the financing order, to revise the amount of specified costs, or in any way to reduce or impair the value of the intangible property right, except as may be contemplated by periodic adjustments authorized by the specified cost recovery legislation.

(c) *Exemption for securitizations of assets issued, insured or guaranteed by the United States.* This part shall not apply to any securitization transaction if the asset-backed securities issued in the transaction are:

(1) Collateralized solely by obligations issued by the United States or an agency

of the United States and servicing assets;

(2) Collateralized solely by assets that are fully insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States (other than those referred to in paragraph (b)(1)(i) of this section) and servicing assets; or

(3) Fully guaranteed as to the timely payment of principal and interest by the United States or any agency of the United States;

(d) *Federal Deposit Insurance Corporation securitizations.* This part shall not apply to any securitization transaction that is sponsored by the Federal Deposit Insurance Corporation acting as conservator or receiver under any provision of the Federal Deposit Insurance Act or of Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

(e) *Reduced requirement for certain student loan securitizations.* The 5 percent risk retention requirement set forth in § __.4 shall be modified as follows:

(1) With respect to a securitization transaction that is collateralized solely by student loans made under the Federal Family Education Loan Program (''FFELP loans'') that are guaranteed as to 100 percent of defaulted principal and accrued interest, and servicing assets, the risk retention requirement shall be 0 percent;

(2) With respect to a securitization transaction that is collateralized solely by FFELP loans that are guaranteed as to at least 98 percent but less than 100 percent of defaulted principal and accrued interest, and servicing assets, the risk retention requirement shall be 2 percent; and

(3) With respect to any other securitization transaction that is collateralized solely by FFELP loans, and servicing assets, the risk retention requirement shall be 3 percent.

(f) *Community-focused lending securitizations.* (1) This part shall not apply to any securitization transaction if the asset-backed securities issued in the transaction are collateralized solely by community-focused residential mortgages and servicing assets.

(2) For any securitization transaction that includes both community-focused residential mortgages and residential mortgages that are not exempt from risk retention under this part, the percent of risk retention required under § __.4(a) is reduced by the ratio of the unpaid principal balance of the community-focused residential mortgages to the total unpaid principal balance of residential mortgages that are included in the pool of assets collateralizing the asset-backed securities issued pursuant to the securitization transaction (the community-focused residential mortgage asset ratio); provided that:

(i) The community-focused residential mortgage asset ratio is measured as of the cut-off date or similar date for establishing the composition of the pool assets collateralizing the asset-backed securities issued pursuant to the securitization transaction; and

(ii) If the community-focused residential mortgage asset ratio would exceed 50 percent, the community-focused residential mortgage asset ratio shall be deemed to be 50 percent.

(g) *Exemptions for securitizations of certain three-to-four unit mortgage loans.* A sponsor shall be exempt from the risk retention requirements in subpart B of this part with respect to any securitization transaction if:

(1)(i) The asset-backed securities issued in the transaction are collateralized solely by qualifying three-to-four unit residential mortgage loans and servicing assets; or

(ii) The asset-backed securities issued in the transaction are collateralized solely by qualifying three-to-four unit residential mortgage loans, qualified residential mortgages as defined in § __.13, and servicing assets.

(2) The depositor with respect to the securitization provides the certifications set forth in § __.13(b)(4) with respect to the process for ensuring that all assets that collateralize the asset-backed securities issued in the transaction are qualifying three-to-four unit residential mortgage loans, qualified residential mortgages, or servicing assets; and

(3) The sponsor of the securitization complies with the repurchase requirements in § __.13(c) with respect to a loan if, after closing, it is determined that the loan does not meet all of the criteria to be either a qualified residential mortgage or a qualifying three-to-four unit residential mortgage loan, as appropriate.

(h) *Rule of construction.* Securitization transactions involving the issuance of asset-backed securities that are either issued, insured, or guaranteed by, or are collateralized by obligations issued by, or loans that are issued, insured, or guaranteed by, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or a Federal home loan bank shall not on that basis qualify for exemption under this part.

§ __.20 Safe harbor for certain foreign-related transactions.

(a) *Definitions.* For purposes of this section, the following definition shall apply:

U.S. person means:

(i) Any of the following:

(A) Any natural person resident in the United States;

(B) Any partnership, corporation, limited liability company, or other organization or entity organized or incorporated under the laws of any State or of the United States;

(C) Any estate of which any executor or administrator is a U.S. person (as defined under any other clause of this definition);

(D) Any trust of which any trustee is a U.S. person (as defined under any other clause of this definition);

(E) Any agency or branch of a foreign entity located in the United States;

(F) Any non-discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a U.S. person (as defined under any other clause of this definition);

(G) Any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated, or (if an individual) resident in the United States; and

(H) Any partnership, corporation, limited liability company, or other organization or entity if:

(*1*) Organized or incorporated under the laws of any foreign jurisdiction; and

(*2*) Formed by a U.S. person (as defined under any other clause of this definition) principally for the purpose of investing in securities not registered under the Act; and

(ii) ''U.S. person(s)'' does not include:

(A) Any discretionary account or similar account (other than an estate or trust) held for the benefit or account of a person not constituting a U.S. person (as defined in paragraph (i) of this section) by a dealer or other professional fiduciary organized, incorporated, or (if an individual) resident in the United States;

(B) Any estate of which any professional fiduciary acting as executor or administrator is a U.S. person (as defined in paragraph (i) of this section) if:

(*1*) An executor or administrator of the estate who is not a U.S. person (as defined in paragraph (i) of this section) has sole or shared investment discretion with respect to the assets of the estate; and

(*2*) The estate is governed by foreign law;

(C) Any trust of which any professional fiduciary acting as trustee is a U.S. person (as defined in paragraph (i) of this section), if a trustee who is not a U.S. person (as defined in paragraph (i) of this section) has sole or shared

investment discretion with respect to the trust assets, and no beneficiary of the trust (and no settlor if the trust is revocable) is a U.S. person (as defined in paragraph (i) of this section);

(D) An employee benefit plan established and administered in accordance with the law of a country other than the United States and customary practices and documentation of such country;

(E) Any agency or branch of a U.S. person (as defined in paragraph (i) of this section) located outside the United States if:

(*1*) The agency or branch operates for valid business reasons; and

(*2*) The agency or branch is engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation, respectively, in the jurisdiction where located;

(F) The International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the United Nations, and their agencies, affiliates and pension plans, and any other similar international organizations, their agencies, affiliates and pension plans.

(b) *In general.* This part shall not apply to a securitization transaction if all the following conditions are met:

(1) The securitization transaction is not required to be and is not registered under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*);

(2) No more than 10 percent of the dollar value (or equivalent amount in the currency in which the ABS interests are issued, as applicable) of all classes of ABS interests in the securitization transaction are sold or transferred to U.S. persons or for the account or benefit of U.S. persons;

(3) Neither the sponsor of the securitization transaction nor the issuing entity is:

(i) Chartered, incorporated, or organized under the laws of the United States or any State;

(ii) An unincorporated branch or office (wherever located) of an entity chartered, incorporated, or organized under the laws of the United States or any State; or

(iii) An unincorporated branch or office located in the United States or any State of an entity that is chartered, incorporated, or organized under the laws of a jurisdiction other than the United States or any State; and

(4) If the sponsor or issuing entity is chartered, incorporated, or organized under the laws of a jurisdiction other than the United States or any State, no more than 25 percent (as determined based on unpaid principal balance) of the assets that collateralize the ABS interests sold in the securitization transaction were acquired by the sponsor or issuing entity, directly or indirectly, from:

(i) A majority-owned affiliate of the sponsor or issuing entity that is chartered, incorporated, or organized under the laws of the United States or any State; or

(ii) An unincorporated branch or office of the sponsor or issuing entity that is located in the United States or any State.

(c) *Evasions prohibited.* In view of the objective of these rules and the policies underlying Section 15G of the Exchange Act, the safe harbor described in paragraph (b) of this section is not available with respect to any transaction or series of transactions that, although in technical compliance with paragraphs (a) and (b) of this section, is part of a plan or scheme to evade the requirements of section 15G and this Part. In such cases, compliance with section 15G and this part is required.

§ __.21 Additional exemptions.

(a) *Securitization transactions.* The federal agencies with rulewriting authority under section 15G(b) of the Exchange Act (15 U.S.C. 78o-11(b)) with respect to the type of assets involved may jointly provide a total or partial exemption of any securitization transaction as such agencies determine may be appropriate in the public interest and for the protection of investors.

(b) *Exceptions, exemptions, and adjustments.* The Federal banking agencies and the Commission, in consultation with the Federal Housing Finance Agency and the Department of Housing and Urban Development, may jointly adopt or issue exemptions, exceptions or adjustments to the requirements of this part, including exemptions, exceptions or adjustments for classes of institutions or assets in accordance with section 15G(e) of the Exchange Act (15 U.S.C. 78o-11(e)).

§ __.22 Periodic review of the QRM definition, exempted three-to-four unit residential mortgage loans, and community-focused residential mortgage exemption

(a) The Federal banking agencies and the Commission, in consultation with the Federal Housing Finance Agency and the Department of Housing and Urban Development, shall commence a review of the definition of qualified residential mortgage in § __.13, a review of the community-focused residential mortgage exemption in § ___.19(f), and a review of the exemption for qualifying three-to-four unit residential mortgage loans in § ____.19(g):

(1) No later than four years after the effective date of the rule (as it relates to securitizers and originators of asset-backed securities collateralized by residential mortgages), five years following the completion of such initial review, and every five years thereafter; and

(2) At any time, upon the request of any Federal banking agency, the Commission, the Federal Housing Finance Agency or the Department of Housing and Urban Development, specifying the reason for such request, including as a result of any amendment to the definition of qualified mortgage or changes in the residential housing market.

(b) The Federal banking agencies, the Commission, the Federal Housing Finance Agency and the Department of Housing and Urban Development shall publish in the **Federal Register** notice of the commencement of a review and, in the case of a review commenced under paragraph (a)(2) of this section, the reason an agency is requesting such review. After completion of any review, but no later than six months after the publication of the notice announcing the review, unless extended by the agencies, the agencies shall jointly publish a notice disclosing the determination of their review. If the agencies determine to amend the definition of qualified residential mortgage, the agencies shall complete any required rulemaking within 12 months of publication in the **Federal Register** of such notice disclosing the determination of their review, unless extended by the agencies.

End of Common Rule

List of Subjects

12 CFR Part 43

Automobile loans, Banks and banking, Commercial loans, Commercial real estate, Credit risk, Mortgages, National banks, Reporting and recordkeeping requirements, Risk retention, Securitization.

12 CFR Part 244

Auto loans, Banks and banking, Bank holding companies, Commercial loans, Commercial real estate, Credit risk, Edge and agreement corporations, Foreign banking organizations, Mortgages, Nonbank financial companies, Reporting and recordkeeping requirements, Risk retention, Savings and loan holding companies, Securitization, State member banks.

12 CFR Part 373

Automobile loans, Banks and banking, Commercial loans, Commercial real estate, Credit risk, Mortgages, Reporting and recordkeeping requirements, Risk retention, Savings associations, Securitization.

12 CFR Part 1234

Government sponsored enterprises, Mortgages, Securities.

17 CFR Part 246

Reporting and recordkeeping requirements, Securities.

24 CFR Part 267

Mortgages.

Adoption of the Common Rule Text

The adoption of the common rule, as modified by agency-specific text, is set forth below:

Department of the Treasury

Office of the Comptroller of the Currency

12 CFR Chapter I

Authority and Issuance

For the reasons stated in the common preamble and under the authority of 12 U.S.C. 93a, 1464, 5412(b)(2)(B), and 15 U.S.C. 78o-11, the Office of the Comptroller of the Currency is adopting the text of the common rule as set forth at the end of the Supplementary Information as part 43, chapter I of title 12, Code of Federal Regulations, and further amends part 43 as follows:

PART 43—CREDIT RISK RETENTION

■ 1. The authority citation for part 43 is added to read as follows:

Authority: 12 U.S.C. 1 *et seq.,* 93a, 161, 1464, 1818, 5412(b)(2)(B), and 15 U.S.C. 78o-11.

■ 2. Section 43.1 is added to read as follows:

§ 43.1 Authority, purpose, scope, and reservation of authority.

(a) *Authority.* This part is issued under the authority of 12 U.S.C. 1 *et seq.,* 93a, 161, 1464, 1818, 5412(b)(2)(B), and 15 U.S.C. 78o-11.

(b) *Purpose.* (1) This part requires securitizers to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party. This part specifies the permissible types, forms, and amounts of credit risk retention, and it establishes certain exemptions for securitizations collateralized by assets that meet specified underwriting standards.

(2) Nothing in this part shall be read to limit the authority of the OCC to take supervisory or enforcement action, including action to address unsafe or unsound practices or conditions, or violations of law.

(c) *Scope.* This part applies to any securitizer that is a national bank, a Federal savings association, a Federal branch or agency of a foreign bank, or a subsidiary thereof.

(d) *Compliance dates.* Compliance with this part is required:

(1) With respect to any securitization transaction collateralized by residential mortgages, on and after December 24, 2015; and

(2) With respect to any other securitization transaction, on and after December 24, 2016.

Federal Reserve System

12 CFR Chapter II

Authority and Issuance

For the reasons set forth in the Supplementary Information, the Board of Governors of the Federal Reserve System is adopting the text of the common rule as set forth at the end of the Supplementary Information as part 244 to chapter II of title 12, Code of Federal Regulations, and further amends part 244 as follows:

PART 244—CREDIT RISK RETENTION (REGULATION RR)

■ 3. The authority citation for part 244 is added to read as follows:

Authority: 12 U.S.C. 221 *et seq.,* 1461 *et seq.,* 1818, 1841 *et seq.,* 3103 *et seq.,* and 15 U.S.C. 78o–11.

■ 4. The part heading for part 244 is revised to read as set forth above.

■ 5. Section 244.1 is added to read as follows:

§ 244.1 Authority, purpose, and scope.

(a) *Authority.* (1) *In general.* This part (Regulation RR) is issued by the Board of Governors of the Federal Reserve System under section 15G of the Securities Exchange Act of 1934, as amended (Exchange Act) (15 U.S.C. 78o–11), as well as under the Federal Reserve Act, as amended (12 U.S.C. 221 *et seq.*); section 8 of the Federal Deposit Insurance Act (FDI Act), as amended (12 U.S.C. 1818); the Bank Holding Company Act of 1956, as amended (BHC Act) (12 U.S.C. 1841 *et seq.*); the Home Owners' Loan Act of 1933 (HOLA) (12 U.S.C. 1461 *et seq.*); section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) (12 U.S.C. 5365); and the International Banking Act of 1978, as amended (12 U.S.C. 3101 *et seq.*).

(2) Nothing in this part shall be read to limit the authority of the Board to take action under provisions of law other than 15 U.S.C. 78o–11, including action to address unsafe or unsound practices or conditions, or violations of law or regulation, under section 8 of the FDI Act.

(b) *Purpose.* This part requires any securitizer to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party in a transaction within the scope of section 15G of the Exchange Act. This part specifies the permissible types, forms, and amounts of credit risk retention, and establishes certain exemptions for securitizations collateralized by assets that meet specified underwriting standards or that otherwise qualify for an exemption.

(c) *Scope.* (1) This part applies to any securitizer that is:

(i) A state member bank (as defined in 12 CFR 208.2(g)); or

(ii) Any subsidiary of a state member bank.

(2) Section 15G of the Exchange Act and the rules issued thereunder apply to any securitizer that is:

(i) A bank holding company (as defined in 12 U.S.C. 1842);

(ii) A foreign banking organization (as defined in 12 CFR 211.21(o));

(iii) An Edge or agreement corporation (as defined in 12 CFR 211.1(c)(2) and (3));

(iv) A nonbank financial company that the Financial Stability Oversight Council has determined under section 113 of the Dodd–Frank Wall Street Reform and Consumer Protection Act (the Dodd–Frank Act) (12 U.S.C. 5323) shall be supervised by the Board and for which such determination is still in effect; or

(v) A savings and loan holding company (as defined in 12 U.S.C. 1467a); and

(vi) Any subsidiary of the foregoing.

(3) Compliance with this part is required:

(i) With respect to any securitization transaction collateralized by residential mortgages on December 24, 2015; and

(ii) With respect to any other securitization transaction on December 24, 2016.

Federal Deposit Insurance Corporation

12 CFR Chapter III

Authority and Issuance

For the reasons set forth in the Supplementary Information, the Federal

Deposit Insurance Corporation adds the text of the common rule as set forth at the end of the Supplementary Information as part 373 to chapter III of title 12, Code of Federal Regulations, and further amends part 373 as follows:

PART 373—CREDIT RISK RETENTION

■ 6. The authority citation for part 373 is added to read as follows:

Authority: 12 U.S.C. 1811 *et seq.* and 3103 *et seq.,* and 15 U.S.C. 78o–11.

■ 7. Section 373.1 is added to read as follows:

§ 373.1 Purpose and scope.

(a) *Authority.* (1) *In general.* This part is issued by the Federal Deposit Insurance Corporation (FDIC) under section 15G of the Securities Exchange Act of 1934, as amended (Exchange Act) (15 U.S.C. 78o–11), as well as the Federal Deposit Insurance Act (12 U.S.C. 1811 *et seq.*) and the International Banking Act of 1978, as amended (12 U.S.C. 3101 *et seq.*).

(2) Nothing in this part shall be read to limit the authority of the FDIC to take action under provisions of law other than 15 U.S.C. 78o–11, including to address unsafe or unsound practices or conditions, or violations of law or regulation under section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818).

(b) *Purpose.* This part requires securitizers to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party in a transaction within the scope of section 15G of the Exchange Act. This part specifies the permissible types, forms, and amounts of credit risk retention, and it establishes certain exemptions for securitizations collateralized by assets that meet specified underwriting standards or that otherwise qualify for an exemption.

(c) *Scope.* This part applies to any securitizer that is:

(1) A state nonmember bank (as defined in 12 U.S.C. 1813(e)(2));

(2) An insured state branch of a foreign bank (as defined in 12 CFR 347.202);

(3) A state savings association (as defined in 12 U.S.C. 1813(b)(3)); or

(4) Any subsidiary of an entity described in paragraph (c)(1), (2), or (3) of this section.

Federal Housing Finance Agency

12 CFR Chapter XII

Authority and Issuance

For the reasons stated in the Supplementary Information, and under the authority of 12 U.S.C. 4526, the Federal Housing Finance Agency is adopting the text of the common rule as set forth at the end of the Supplementary Information as part 1234 of subchapter B of chapter XII of title 12 of the Code of Federal Regulations, and further amends part 1234 as follows:

PART 1234—CREDIT RISK RETENTION

■ 8. The authority citation for part 1234 is added to read as follows:

Authority: 12 U.S.C. 4511(b), 4526, 4617; 15 U.S.C. 78o–11(b)(2).

■ 9. Section 1234.1 is added to read as follows:

§ 1234.1 Purpose, scope and reservation of authority.

(a) *Purpose.* This part requires securitizers to retain an economic interest in a portion of the credit risk for any residential mortgage asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party in a transaction within the scope of section 15G of the Exchange Act. This part specifies the permissible types, forms, and amounts of credit risk retention, and it establishes certain exemptions for securitizations collateralized by assets that meet specified underwriting standards or that otherwise qualify for an exemption.

(b) *Scope.* (1) Effective December 24, 2015, this part will apply to any securitizer that is an entity regulated by the Federal Housing Finance Agency with respect to a securitization transaction collateralized by residential mortgages.

(2) Effective December 24, 2016, this part will apply to any securitizer that is an entity regulated by the Federal Housing Finance Agency with respect to a securitization transaction collateralized by assets other than residential mortgages.

(c) *Reservation of authority.* Nothing in this part shall be read to limit the authority of the Director of the Federal Housing Finance Agency to take supervisory or enforcement action, including action to address unsafe or unsound practices or conditions, or violations of law.

■ 10. Amend § 1234.14 as follows:

■ a. Revise the section heading;

■ b. In the introductory text, remove the reference ''§§ 1234.15 through 1234.18'' and add in its place the reference ''§§ 1234.15 and 1234.17'';

■ c. Remove the definitions of ''Automobile loan'', ''Commercial loan'', ''Debt to income (DTI) ratio'', ''Earnings before interest, taxes, depreciation, and amortization (EBITDA)'', ''Leverage Ratio'', ''Model year'', ''Payments-in-kind'', ''Purchase price'', ''Salvage title'', ''Total debt'', ''Total liabilities ratio'', and ''Trade-in allowance''; and

■ d. Revise the definition of ''Debt service coverage (DSC) ratio''.

The revisions read as follows:

§ 1234.14 Definitions applicable to qualifying commercial real estate loans.

* * * * *

Debt service coverage (DSC) ratio means the ratio of:

(1) The annual NOI less the annual replacement reserve of the CRE property at the time of origination of the CRE loan(s); to

(2) The sum of the borrower's annual payments for principal and interest (calculated at the fully indexed rate) on any debt obligation.

* * * * *

■ 11. Revise § 1234.15 to read as follows:

§ 1234.15 Qualifying commercial real estate loans.

(a) *General exception.* Commercial real estate loans that are securitized through a securitization transaction shall be subject to a 0 percent risk retention requirement under subpart B of this part, provided that the following conditions are met:

(1) The CRE assets meet the underwriting standards set forth in § 1234.17;

(2) The securitization transaction is collateralized solely by CRE loans and by servicing assets;

(3) The securitization transaction does not permit reinvestment periods; and

(4) The sponsor provides, or causes to be provided, to potential investors a reasonable period of time prior to the sale of asset-backed securities of the issuing entity, and, upon request, to the Commission, and to the FHFA, in written form under the caption ''Credit Risk Retention'' a description of the manner in which the sponsor determined the aggregate risk retention requirement for the securitization transaction after including qualifying CRE loans with 0 percent risk retention.

(b) *Risk retention requirement.* For any securitization transaction described in paragraph (a) of this section, the percentage of risk retention required under § 1234.3(a) is reduced by the percentage evidenced by the ratio of the unpaid principal balance of the qualifying CRE loans to the total unpaid principal balance of CRE loans that are included in the pool of assets collateralizing the asset-backed securities issued pursuant to the securitization transaction (the qualifying asset ratio); provided that;

(1) The qualifying asset ratio is measured as of the cut-off date or similar date for establishing the composition of the securitized assets collateralizing the asset-backed securities issued pursuant to the securitization transaction;

(2) If the qualifying asset ratio would exceed 50 percent, the qualifying asset ratio shall be deemed to be 50 percent; and

(3) The disclosure required by paragraph (a)(4) of this section also includes descriptions of the qualifying CRE loans and descriptions of the CRE loans that are not qualifying CRE loans, and the material differences between the group of qualifying CRE loans and CRE loans that are not qualifying loans with respect to the composition of each group's loan balances, loan terms, interest rates, borrower credit information, and characteristics of any loan collateral.

(c) *Exception for securitizations of qualifying CRE only.* Notwithstanding other provisions of this section, the risk retention requirements of subpart B of this part shall not apply to securitization transactions where the transaction is collateralized solely by servicing assets and qualifying CRE loans.

(d) Record maintenance. A regulated entity must retain the disclosures required in paragraphs (a) and (b) of this section and the certification required in § 1234.17(a)(10) of this part, in its records until three years after all ABS interests issued in the securitization are no longer outstanding. The regulated entity must provide the disclosures and certifications upon request to the Commission and the FHFA.

§§ 1234.16 and 1234.18 [Removed and Reserved]

■ 12. Remove and reserve §§ 1234.16 and 1234.18.

Securities and Exchange Commission

17 CFR Chapter II

Authority and Issuance

For the reasons stated in the Supplementary Information, the Securities and Exchange Commission is adopting the text of the common rule as set forth at the end of the Supplementary Information as part 246, title 17, chapter II of the Code of Federal Regulations, under the authority set forth in Sections 7, 10, 19(a), and 28 of the Securities Act and Sections 3, 13, 15, 15G, 23 and 36 of the Exchange Act, and further amends part 246 as follows:

PART 246—CREDIT RISK RETENTION

■ 13. The authority citation for part 246 is added to read as follows:

Authority: 15 U.S.C. 77g, 77j, 77s, 77z–3, 78c, 78m, 78o, 78o–11, 78w, 78mm.

■ 14. Section 246.1 is added to read as follows:

§ 246.1 Purpose, scope, and authority.

(a) *Authority and purpose.* This part (Regulation RR) is issued by the Securities and Exchange Commission (''Commission'') jointly with the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and, in the case of the securitization of any residential mortgage asset, together with the Secretary of Housing and Urban Development and the Federal Housing Finance Agency, pursuant to Section 15G of the Securities Exchange Act of 1934 (15 U.S.C. 78o–11). The Commission also is issuing this part pursuant to its authority under Sections 7, 10, 19(a), and 28 of the Securities Act and Sections 3, 13, 15, 23, and 36 of the Exchange Act. This part requires securitizers to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party. This part specifies the permissible types, forms, and amounts of credit risk retention, and establishes certain exemptions for securitizations collateralized by assets that meet specified underwriting standards or otherwise qualify for an exemption.

(b) The authority of the Commission under this part shall be in addition to the authority of the Commission to otherwise enforce the federal securities laws, including, without limitation, the antifraud provisions of the securities laws.

Department of Housing and Urban Development

24 CFR Chapter II

Authority and Issuance

For the reasons stated in the preamble, HUD is adopting the text of the common rule as set forth at the end of the Supplementary Information as 24 CFR part 267, and further amends part 267 as follows:

PART 267—CREDIT RISK RETENTION

■ 15. The authority citation for part 267 is added to read as follows:

Authority: 15 U.S.C. 78–o–11; 42 U.S.C. 3535(d).

■ 16. Section 267.1 is added to read as follows:

§ 267.1 Credit risk retention exceptions and exemptions for HUD programs.

The credit risk retention regulations codified at 12 CFR part 43 (Office of the Comptroller of the Currency); 12 CFR part 244 (Federal Reserve System); 12 CFR part 373 (Federal Deposit Insurance Corporation); 17 CFR part 246 (Securities and Exchange Commission); and 12 CFR part 1234 (Federal Housing Finance Agency) include exceptions and exemptions in subpart D of each of these codified regulations for certain transactions involving programs and entities under the jurisdiction of the Department of Housing and Urban Development.

Dated: October 21, 2014.

Thomas J. Curry,

Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, October 23, 2014.

Robert deV. Frierson,

Secretary of the Board.

Dated at Washington, DC, this 21st day of October, 2014.

By order of the Board of Directors.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

Dated: October 22, 2014.

By the Securities and Exchange Commission.

Kevin M. O'Neill,

Deputy Secretary.

Dated: October 21, 2014.

Melvin L. Watt,

Director, Federal Housing Finance Agency.

By the Department of Housing and Urban Development.

Julián Castro,

Secretary.

[FR Doc. 2014–29256 Filed 12–23–14; 8:45 am]

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