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Risk Retention Rules for Securitization of Mortgages and Other Financial Assets

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As the deadline set by the Dodd-Frank Act approaches, six regulatory agencies announced that during the course of this week, all of them would consider a uniform joint regulation to implement Section 941(b) of that Act. This is the section of the Act that requires securitizers to retain at least 5% of the risk associated with the financial assets they securitize. This is sometimes referred to as "skin in the game."

Based on unofficial information about the contents of the proposal, we understand that if the six agencies adopt it without change, it will contain the following rules.

Residential Mortgage Loans A key concept is the "qualified residential mortgage" definition. The Act allows the regulations to make an exception to the 5% risk retention requirement for "qualified residential mortgages" as defined by the regulators. The proposed regulations define this category very stringently, as follows:

- Loan-to-value ratio no greater than 80% for a home purchase.
- Loan-to-value ratio no greater than 75% for a refinance where no cash is taken out.

- Loan-to-value ratio no greater than 70% for a refinance where cash is taken out.
- 20% down payment for a purchase transaction.
- Front-end (i.e., mortgage only) debt-to-income ratio no greater than 28%.
- Back-end (i.e., mortgage plus other recurring) debt-to-income ratio no greater than 36%.
- No 60-day delinquency on any debt within the last 24 months.

Other Financial Asset Categories For loans other than residential mortgage loans, the proposal contemplates a similarly narrow set of characteristics that would avoid the 5% risk retention. For auto loans, the credit quality would have to be determined as if the loan was unsecured. For commercial mortgage loans, income from the property would have to be stable and sufficient to cover debt service. For unsecured commercial credit, the borrower's business would need to support the credit decision.

Who Retains the 5%? The proposal mandates that the "sponsor" of the securitization be the party that retains the 5% interest. It is permitted, but not required, that the sponsor allocate part of the retained risk to the originator, through a contractual arrangement with the sponsor.

Form of the Risk Retention The proposal allows a variety of choices as to how the 5% risk is retained. They include "vertical" slices, first-loss positions, and other arrangements for holding interests within the securitized pool, as well as representative samples. For commercial mortgage-backed securities (CMBS), the risk retention can be in the form of a subordinated "B-piece."

For Fannie Mae and Freddie Mac, the guarantees that they give are considered risk retention, at least for so long as they are operating under the governmental conservatorships.

Although the Act prohibits hedging or transferring the interest that constitutes the required retention, the proposal would allow the interest to be pledged, as long as this is done on a full-recourse basis.

Securitization Process The process of selecting assets for a securitization must be handled pursuant to internal rules that are designed to ensure that the loans match the underwriting criteria prescribed for the transaction. A certification will be required.

Rulemaking Process There is no assurance that all six regulatory agencies will accept the current formulation of the proposal this week. If they do, the result will be the issuance of a Notice of Proposed Rulemaking. That will start the process of receiving comments from members of the public. Only after the comment period and whatever revisions are made in response to the comments would the new rules become final.