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A legal update from Dechert's Financial Institutions and Finance and Real Estate Groups

Risk Retention Proposal for Residential Mortgages Comes into Focus

Federal regulators have set the stage for a robust public debate and comment period on their proposed risk retention rules under Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). Many constituencies have recognized that the final form of these rules has the potential to have a significant impact on the cost and availability of a wide range of consumer and commercial credit, including residential mortgages. On May 13, 2011, fifteen groups representing both financial services industry participants and consumers requested that the comment period on the proposed rules be extended from June 10, 2011 to July 22, 2011.

One of the most discussed aspects of the proposed rules is their impact on the availability of residential mortgages. See our March *DechertOnPoint* "Risk Retention and Residential Mortgages: Legislation, Regulation and Economics" for additional information. In this update, we focus on the scope of the exception for qualifying residential mortgages ("QRMs") and a variety of specific concerns raised by the proposed risk retention requirements that could make the costs of securitizing residential mortgages prohibitively high.

Scope of the QRM Exemption

Representatives from a number of federal regulatory agencies shared their perspectives on the issues related to residential mortgages at a recent hearing of the House Financial Services Committee's Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises (the "Subcommittee"). Among the key points made by the regulators in their written statements were the following:

- The agencies believe that Congress intended that risk retention be the norm and that exceptions should be narrowly drawn.
- Historically, only approximately 20% of residential mortgage loans would have met the requirements to be treated as a QRM.
- When loan underwriting standards have fallen below the proposed QRM standards, loan delinquency rates have risen sharply.
- A narrow QRM definition will not adversely impact potential borrowers who do not qualify for QRM loans. Risk retention for non-QRM loans should result in only a nominal additional cost to non-QRM borrowers.
- By establishing a narrow QRM market, the rule will ensure that the non-QRM market will be cost-effective for low- and moderate-income borrowers and will be large enough to ensure a vibrant and liquid secondary market for non-QRMs.
- The regulators are willing to consider measures to mitigate the impact of proposed rigorous QRM standards, including taking into account the impact of private

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mortgage insurance and establishing a less than 5% risk retention requirement for high quality non-QRM loans.

- The proposal's treatment of Fannie Mae and Freddie Mac ("GSEs") guarantees as satisfying the risk retention requirements (the "GSE Exception") is appropriate given the structure of those guarantees and the U.S. government involvement with the GSEs. Requiring risk retention by the GSEs would require them to expand their portfolios and to issue more corporate debt but would not have any material effect on the economics of their securitizations or their incentives as sponsors.

Notwithstanding the regulators' statements, many members of the Subcommittee expressed concern that the 80% maximum loan-to-value requirement in the QRM definition would prevent many high-quality loans from meeting the QRM requirements. Subcommittee members also expressed concern regarding the impact that the proposed rule would have on community banks.

It seems clear from the testimony in the subcommittee that the regulators have developed a set of economic assumptions in connection with their determinations regarding the scope of the proposed standard for QRMs. These appear to be based on an expectation that securitizers and originators will be prepared to bear the economic impact of risk retention with little or no impact on the amount or cost of non-QRM credit.

Comments on the proposed rule that provide empirical support for arguments regarding the likely response of the housing finance industry to the proposed scope of the QRM definition, either with or without the GSE Exception, are likely to be given serious consideration by the agencies as they develop a final rule.

Risk Retention Option Concerns

Market participants have begun raising concerns regarding the myriad of issues that could arise if the proposed regulations are enacted in their current iteration. Certain of these concerns are summarized below.

Representative Sample

Concerns have been raised that certain proposed forms of risk retention may make compliance difficult and could reduce the liquidity and the additional investor protections sought by regulators. For example, industry participants are not confident that the proposal for representative sample risk retention would be workable in practice. Because of the requirement that there be a minimum of 1,000 assets included in the pool from which the sample is drawn, compliance would likely prove to be very burdensome even for residential mortgage securitizations and particularly for asset classes that traditionally have had far fewer assets in their pools. Even if this aspect of the requirement were to be removed from the final rule, it would still be very difficult to create a sampling of loans containing all of the material characteristics of the securitized pool to the degree required under the proposed regulations.[1]

Premium Capture Cash Reserve Account

Another example of risk retention that has created considerable concern amongst industry participants is the requirement that a premium capture cash reserve account be established in certain transactions, which would essentially serve as the first-loss piece of the transaction. The intent of this requirement is to prevent the upfront monetization of excess spread by the sponsor. The regulators are concerned that by monetizing excess spread the sponsor could negate the economic exposure it is otherwise required to retain under the regulations. The proceeds of a bond offering that exceed 95% of the bonds' par value would be required to be directed into the reserve, which would cover any losses in the collateral pool and could not be disbursed until all of the bonds with outstanding principal balances pay off. Thus, as proposed, issuers in these deals would have no incentive to divert excess interest from the collateral pool into an interest-only strip sold at issuance.

Without the ability to monetize excess spread, however, many sponsors will simply be unwilling or even unable to utilize securitization. Market participants will only use securitization if it can be done profitably. The premium capture cash reserve account requirement will also disproportionately affect the amount of credit made available to non-prime borrowers. Loans to non-prime borrowers are generally made at higher interest rates than comparable loans to prime borrowers. These proposed rules remove an originator's incentive to lend

[1] Board of Governors of the Federal Reserve System, Department of Housing and Urban Development, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Office of the Comptroller of the Currency and Securities and Exchange Commission, Joint Release No. 2011-79 - Credit Risk Retention (proposed § _.8), *available at*, http://sec.gov/rules/proposed/2011/34-64148.pdf.

to non-prime borrowers because any excess spread from a securitization of non-prime loans will not be realized by the originator but instead will be trapped inside the securitization to cover potential losses. To the extent that securitizations occur if the proposed rules take effect as written, the collateral pools will be much less likely to contain anything other than loans to the borrowers with the most pristine credit history. For everyone else, residential mortgage credit may be restricted and more costly.

Definitional Concerns

An additional concern that has been raised relates to the definition of "par value." While par value of a security is generally understood in the market to refer to the stated value or face amount of the security, market participants are concerned that the regulators may have intended to define "par value" as related to or involving a calculation of the fair value of the securities issued. This would make a significant difference in terms of compliance with risk retention rules and may in fact make the proposed rule for the premium capture cash reserve account one that could be complied with while maintaining a sponsor's ability to realize sufficient profits. To the extent that the regulators intend to follow a "fair value" approach, the key issue then becomes what method to use in calculating fair value.

Conclusion

The multi-agency structure of the proposed rules will, as a practical matter, create a relatively high barrier for future adjustments to any final rule and for the issuance of interpretive guidance. This places a premium on industry participants providing the regulators with broad input in order to provide the best opportunity for the final regulations to be drafted in a manner that will maximize the ability of the securitization markets to function effectively in a risk retention environment.[2]

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2 *Id.* at proposed § _.23(a) (authorizing the agencies to jointly issue a total or partial exemption of any securitization transaction as the agencies determine to be in the public interest and for the protection of investors); *Id.* at proposed § _.23(b) (authorizing the agencies to jointly adopt or issue exemptions or adjustments to the risk retention rule).

Practice group contacts

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