

Corporate & Financial Weekly Digest

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Agencies Seek Comment on Risk Retention "Skin in the Game" Proposal

Six federal agencies, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission, the Federal Housing Finance Agency, and the Department of Housing and Urban Development, are seeking comment on a proposed rule, approved by the FDIC on March 30, that would require sponsors of asset-backed securities (ABS) to retain at least 5% of the credit risk of the assets underlying the securities and would not permit sponsors to transfer or hedge that credit risk. The proposal, totaling 376 pages in length, would provide sponsors with various options for meeting the risk-retention requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The options include but are not necessarily limited to: (1) a "vertical" slice of the ABS interests, whereby the sponsor or other entity retains a specified *pro rata* piece of every class of interests issued in the transaction; (2) a "horizontal" first-loss position, whereby the sponsor or other entity retains a subordinate interest in the issuing entity that bears losses on the assets before any other classes of interests; (3) a "seller's interest" in securitizations structured using a master trust collateralized by revolving assets whereby the sponsor or other entity holds a separate interest that is *pari passu* with the investors' interest in the pool of receivables (unless and until the occurrence of an early amortization event); or (4) a representative sample, whereby the sponsor retains a representative sample of the assets to be securitized that exposes the sponsor to credit risk that is equivalent to that of the securitized assets. The proposed rules also include disclosure requirements that are an integral part of and specifically tailored to each of the permissible forms of risk retention.

As required by the Dodd-Frank Act, the proposal includes descriptions of loans that would not be subject to these requirements, including ABS that are collateralized exclusively by residential mortgages that qualify as "qualified residential mortgages" (QRMs). The proposal would establish a definition for QRMs—incorporating such criteria as borrower credit history, payment terms, and loan-to-value ratio—designed to ensure they are of very high credit quality. These underwriting standards include, among other things, maximum front-end and back-end debt-to-income ratios of 28% and 36%, respectively; a maximum loan-to-value (LTV) ratio of 80% in the case of a purchase transaction (with a lesser combined LTV permitted for refinance transactions); a 20% down payment requirement in the case of a purchase transaction; and credit history restrictions. The narrow definition of QRMs in the proposal has been heavily criticized by various industry groups, but defended by the FDIC as consistent with the intent of the Dodd-Frank Act. The proposed rule also has a 0% risk-retention requirement for ABS collateralized exclusively by commercial loans, commercial mortgages, or automobile loans that meet certain

underwriting standards. As with QRMs, these underwriting standards are designed to be robust and to ensure that the loans backing the ABS are of very low credit risk.

The proposed rule also includes investor disclosure requirements regarding material information concerning the sponsor's retained interests in a securitization transaction. The disclosures would provide investors and the agencies with a mechanism to monitor compliance with the risk-retention requirements of the proposed rules.

The proposed rule would also recognize that the 100% guarantee of principal and interest provided by Fannie Mae (the Federal National Mortgage Association) and Freddie Mac (the Federal Home Mortgage Loan Corporation) meets their risk-retention requirements as sponsors of mortgage-backed securities for as long as Fannie Mae and Freddie Mac are in conservatorship or receivership with capital support from the U.S. government.

The agencies request comments on the proposed rule by June 10.

Read more.

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