June 10, 2011

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Office of the Comptroller of the Currency
250 E Street, SW., Mail Stop 2-3
Washington, DC 20219
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Securities and Exchange Commission
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Washington, DC 20549-1090
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File Number S7-14-11
RIN 3235-AK96

Board of Governors of the Federal Reserve System
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Attn: Jennifer J. Johnson, Secretary
Docket No. 2011-1411
RIN 7100-AD-70

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RIN 2590-AA43

Federal Deposit Insurance Corporation
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Attn.: Comments, Robert E. Feldman, Executive Secretary
RIN 3064-AD74

Department of Housing and Urban Development
Regulations Division
Office of General Counsel
451 7th Street, SW, Room 10276
Washington, DC 20410-0500
RIN 2501-AD53

Re: <u>Credit Risk Retention; Proposed Rule</u>

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association ("SIFMA")[1] is pleased to respond to the request for comment by the Department of the Treasury, Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (the "Banking Agencies"); the Securities and Exchange Commission (the "SEC" or the "Commission"); and the Federal Housing Finance Agency and the Department of

[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, please visit www.sifma.org.

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Housing and Urban Development (collectively, the "Agencies")[2] on the Agencies' jointly-proposed rules to implement the requirements of section 941(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), which is codified as new Section 15G of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). We refer in this letter to the proposed rules and the accompanying supplementary information collectively as the "Proposing Release."[3]

SIFMA is a diverse organization whose membership includes many of the largest and most significant participants in the United States capital markets. Our members and their affiliates include financial institutions that originate consumer and commercial loans of various types; financial institutions that sponsor securitization transactions; special-purpose companies that issue asset-backed securities ("ABS") and other structured finance products; broker-dealers that act as underwriters, placement agents or initial purchasers in offerings of structured finance products; and asset managers that include experienced investors in ABS.

This letter reflects the considered views of our member financial institutions that act as originators, as securitization sponsors or issuers, or as underwriters, placement agents or initial purchasers in securitization transactions (which we refer to for purposes of this letter as our "originator, sponsor and dealer members"). The views of our asset manager and investor members are reflected in a letter that will be submitted separately. Throughout this letter, references to "we" and to "our" views are to those of our originator, sponsor and dealer members, and to their views regarding the proposed rules.

The letter reflects the initial comments of our originator, sponsor and dealer members on the proposed rules. We expect to provide additional, detailed comments on certain aspects of the proposed rules prior to the close of the comment period. For the reasons discussed below, we believe that, notwithstanding the Agencies' decision to extend the comment period until August 1, 2011, it is important that the proposed rules be reconsidered and republished in proposed form for further public comment before final risk retention rules are adopted.

SIFMA wishes to extend our thanks to each of the Agencies for the obvious care and extraordinary effort involved in generating a proposed rulemaking as complex and comprehensive as the Proposing Release. You were indeed assigned a daunting task under Section 941(b) of the Dodd-Frank Act. We also wish to extend our appreciation to those members of the staffs of various of the Agencies who took the time to speak with us and to explain their view of the intent of certain provisions of the proposed rules. Although we believe

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[2] When we refer to "the Agencies" in this letter, we refer to the appropriate Agencies having rulewriting authority with respect to any particular aspect of the proposed rules.
[3] Credit Risk Retention, 76 Fed. Reg. 24090 (April 29, 2011) [hereinafter the "Proposing Release"].

that in important ways the proposed rules should be revised, we recognize that credit risk retention has been mandated by statute, and we appreciate and support many aspects of the proposed rules. We have endeavored to offer thoughtful comments and constructive recommendations for improvement of the proposed rules.

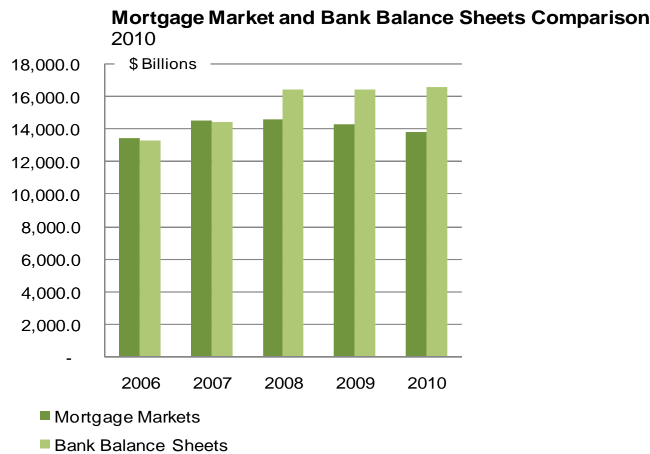
We appreciate your consideration of our views, and we are most eager to make our staff and representatives of our originator, sponsor and dealer members available to discuss any of the issues raised in this letter at a time and place convenient to you.

Our Principal Concerns

(1) The Lack of a Demonstration of Economic Impact Analysis is Disconcerting. The proposed rules would affect every securitized asset class to some extent, and would likely fundamentally reshape substantial portions of the securitization markets. They would change market practices, and impose specific economic costs on securitizers, which will likely be passed on to consumers of credit. We are concerned that the impact on certain asset classes would be extreme, and detrimental to borrowers and the broader economy. As the Agencies know, securitization is a key component of long term, stable funding for banks and other lenders. As much as mistakes in securitization were a detriment to safety and soundness over the past few years, going forward, responsible securitization must be a necessary component of bank capital and balance sheet management strategies. The recovery of these markets is critical to the provision of credit, the long term health of the banking system and the broader financial markets that interact with it. Therefore, rules that seek to address past bad practices must also foster active, liquid, and transparent markets in the future.

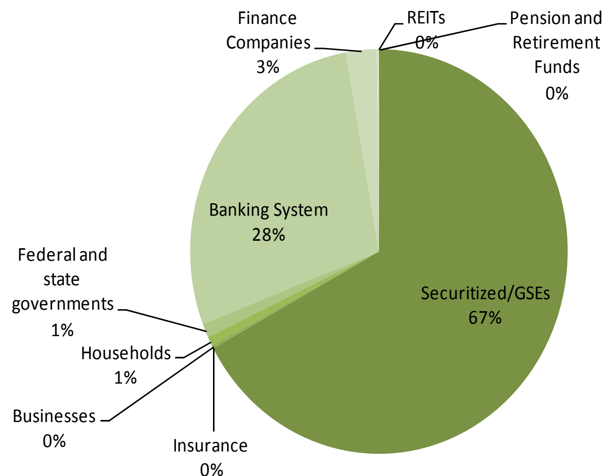
Bank balance sheets cannot simply replace the credit financed by securitization should it not recover. Examining the mortgage markets as an example makes this point clear:

1. The size of the mortgage markets has previously exceeded, and currently nearly equals, the total size of bank balance sheets.



Source: Federal Reserve, SIFMA

2. Residential mortgage loans constitute more than $10 trillion of the total in the figure above. Two-thirds of these mortgage loans are held in securitization trusts or on the balance sheets of the GSEs.



Source: Federal Reserve, SIFMA

Mortgage markets are just one part of the credit spectrum, albeit the largest. The point of this example is to make clear that the banking system cannot, and does not, support the totality of

credit creation on its own. Securitization is a necessary component of the modern U.S. financial system and other financial systems that is a necessary element of credit creation and provides, in general, high quality fixed income assets for various types of investors.

Given this importance of securitization to credit creation, the wide-ranging effects of this rulemaking clearly demand extremely careful economic and public policy consideration. It is important that the costs of compliance with the risk retention rules, in their proposed form or in a modified form, be compared to and balanced with the expected benefits. The potential benefit to borrowers (both individual and corporate) from improvements to lending standards is clear, but this benefit should be balanced against the cost, which includes the impact on the availability of credit. It is generally recognized that the adoption of the risk retention rules will, to an extent to be determined, generally increase the cost of credit. An economic and social analysis of these costs versus the benefits the regulations would confer is therefore imperative.

In addition to the costs imposed by the risk retention rules, we cannot ignore the potential costs imposed by other prudential rulemakings related to the Dodd-Frank Act as well as efforts outside of the Dodd-Frank Act, such as revisions to Basel capital standards and the implementation of Basel III, and proposals for reform of the GSEs and consideration of the future role of the Federal Government in housing finance in the U.S. We also note that the accounting standards embodied in FAS 166 and 167 interact with the proposed risk retention rules in critical ways, and will impact decisions made by securitizers. We do not comment substantively on the merits of these issues, rather, we reference them to place a fine point on the fact that a confluence of events is occurring at the same time, each with an individual impact that is not known, and a total effect that may be equal, or possibly greater than, the sum of its parts.

In any case, we believe that the Proposing Release must be viewed in this broad, global context, and its impact on financial markets, lending markets, and consumers must be examined in this light. It does not appear, based on a review of the Proposing Release, that such an examination has yet occurred.

Furthermore, nothing in the Dodd-Frank Act compels, and nothing in the Proposing Release establishes a commitment by, the regulators to review the impact of the rules in a global context after they are implemented. Without expressing any intended outcome, we believe it is critical that the impact of the credit risk retention rules be reviewed periodically after implementation. Economic factors and markets change over time, and it is vital that the credit risk retention rules be monitored on a more formal, ongoing basis. Given the direct impact of these rules on market dynamics and the availability of credit, we believe that failing to review their impact would be a mistake.

(2) Key Concepts in the Proposed Rules are Not Defined and Not Understood. Several aspects of the proposal require clarification. These include the meaning of "par value" and the nature of an "ABS interest" – key concepts under the proposed rules – as well as various features of the risk retention options and exemptions. We discuss these below. We also address ways in which we believe the proposed rules can be made more flexible, and can be refined to avoid disproportionately adverse effects on particular types of ABS, while still fulfilling both the letter and spirit of Section 941(b) of the Dodd-Frank Act.

(3) The Premium Capture Provisions Could Destroy the Chances for Recovery of Many Securitization Markets and Should be Removed. We are greatly concerned that the impact on some segments of the ABS markets of the proposed premium capture provisions would be severe. If, as we believe, the Agencies intend that the premium capture provisions would operate in combination with a "market value" concept of "par value," securitization would no longer be feasible for many companies. The effect of these provisions could be to render many securitizations uneconomical by substantially increasing the amount of risk required to be retained and reducing or eliminating the profitability of securitization transactions. We discuss in detail below reasons that the premium capture provisions should be omitted from the final rules.

(4) The Rules Are Too Blunt, and Will Cause Collateral Damage. The need for fundamental reconsideration of the approach taken by the Agencies to fulfilling the statutory mandate that credit risk be retained in most securitizations could hardly be more urgent. The "premium capture" provisions of the proposed rules, combined with the unpublished view of some representatives of the Agencies that the amount of risk retained should be calculated in a manner different than anyone in the capital markets contemplated – and potentially far larger, we believe, than Congress contemplated – could be so burdensome that significant segments of the ABS markets could simply shut down. We believe that Congress intended what the Dodd-Frank Act provides for, and that is retention of at least 5 percent of the credit risk related to securitized assets – not an artificial mechanism to limit profitability and discourage securitization. As we discuss in detail below, what is called for is a straightforward, clear, flexible approach to the credit risk retention rules, stripped of the inappropriate additional provisions that would artificially inflate the retained exposure based on some concept of "market value" or "premium capture."

In addition, the proposed rules (with a few exceptions) would apply a broad brush to addressing risk retention for most asset classes, even those with demonstrated strong performance track records, and would impose a risk retention regime that is too rigid for practical application in a dynamic market where decisions must be made on the basis of not only regulatory but also economic considerations.

SIFMA has described the potential impact of the proposed risk retention rules as "monumental," and we do not exaggerate. These proposed rules are too important to be rushed. They are complex and far-reaching. Yet, it appears that under the pressure of the deadline imposed by the Dodd-Frank Act, some aspects of the proposed rules may not have received adequate consideration. We urge the Agencies to step back, reconsider the proposal, and take the time needed to get it right. It is important that the final rules be carefully considered, clear, and tailored to the disparate types of ABS that have such widely varying performance histories and characteristics.

We do not seek in this letter to argue against the fundamental requirement that as a general matter retention of credit risk should be required in securitization transactions, subject to appropriate limitations, exceptions and exemptions, as contemplated by Section 941(b) of the Dodd-Frank Act. Indeed SIFMA, as an institution, has been on the record in support of calibrated credit risk retention requirements for a number of years. Congress and the President have spoken; the debate over whether mandatory risk retention will be required has been settled. But it is vitally important that the regulations that implement Section 941(b) of the Dodd-Frank Act do so in a manner that accomplishes the statute's purposes without doing more damage to the capital markets than is necessary and reducing the availability of credit. The impact of these rules will be so broadly and deeply felt in so many segments of society that clarity, specificity, and appropriate flexibility are crucial.

We note with concern that some market participants are so disheartened by the approach taken by the Agencies in drafting the proposed credit risk retention rules that they are speaking in terms of having one year, or two years, remaining "to get deals done" – a reference to the effective dates of the risk retention rules for residential mortgage-backed securities and other ABS, respectively. The industry as a whole needs to be able to approach implementation of the proposed rules in a positive, constructive spirit. In order to do that, we will need sensible, reasonable rules that will fulfill the statutory mandate for "skin in the game" while still permitting securitization transactions to take place.

(5) The Rules Should Be Revised, Clarified, and Re-Proposed for Comment. Most market participants and other affected parties likely have not had, as we have, the benefit of discussions with representatives of some of the Agencies regarding aspects of the proposed rules that are unclear, such as the meaning of "par value" and how it is to be computed, the application of the premium capture provisions, and the scope of "ABS interest." These parties may be unaware of the fundamental ambiguities in the proposed risk retention regime. It would be unfair to market participants and to those who rely on the availability of credit that is facilitated

by securitization to impose final credit risk retention rules without providing an adequate opportunity for public comment.

We urge the Agencies to take the time needed to carefully reevaluate the proposed rules, perform a risk/benefit analysis of the rules and their potential effects, and republish the rules in proposed form in order to provide a fair and reasonable opportunity for public comment.

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Summary of Comments

The Need for Broad, Careful Analysis and Greater Clarity

- A rulemaking of this magnitude calls for a thorough risk/benefit analysis, and we urge the Agencies to undertake that analysis before adopting final regulations.

- The risk retention rules should be adopted in a form that is clearly understood by the regulated securitizers and flexible in implementation, but that is not so complex and burdensome as to deter securitization.

The Need for Risk Retention Requirements Tailored to Different Types of ABS

- As stated by the Board of Governors of the Federal Reserve in its report to Congress on Risk Retention, "simple credit risk retention rules, applied uniformly across assets of all types, are unlikely to achieve the stated objective of the Act – namely, to improve the asset-backed securitization process and protect investors from losses associated with poorly underwritten loans."[4] We agree. The proposed rules should be reexamined and revised to accommodate the important differences among various types of ABS, many of which exhibited strong performance during the recent financial crisis.

The Risk Retention Requirement Should Terminate After a Reasonable Time

- The goals of Congress and the Agencies in establishing a credit risk retention framework can be accomplished without requiring that risk exposure be retained for the life of every transaction. There should be realistic sunset provisions for risk retention requirements.

The Proposed Rules Should Be Revised and Re Proposed for Public Comment

- We urge the Agencies to reconsider and revise this highly complex and difficult set of regulations, undertake a careful risk/benefit analysis, and republish the proposed rules for public comment, so that all parties affected by the proposed rules can have a fair

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[4] The Board of Governors of the Federal Reserve System, Report to Congress on Risk Retention (October 2010) [hereinafter "Federal Reserve Report"] at 3, available at http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf.

opportunity to review a coherent set of rules and offer constructive and useful comments.

The Agencies' Approach to Risk Retention Should be Reexamined

- If the Agencies truly intend that the premium capture provisions would operate to require horizontal risk retention in an amount equal not just to 5 percent of the maximum possible credit risk but instead a larger amount equal to 5 percent of gross proceeds, securitization could be abandoned across large segments of the capital markets. If, however, it is intended that the horizontal exposure should be in an amount that represents at least 5 percent of the net present value of the total expected cash flows from the pool assets, assuming no defaults or losses, this standard may be feasible for many asset classes. We believe that reasonable restrictions designed to prevent transaction structures that artificially reduce the value of a residual interest may be appropriate, if properly tailored.

- The meaning of "par value" and, as a consequence, the measurement of retained risk exposure, should be carefully reconsidered. The proposed rules are unclear on this vital point, although we believe that the Agencies intend that "par value" should generally equal "market value." In addition, the Agencies appear not to have contemplated that artificially increased or reduced balances for ABS interests could create significant structuring and compliance challenges, and could be difficult to accommodate under the REMIC provisions that govern most securitizations of residential and commercial real estate loans.

- The premium capture provisions are inappropriate and should be withdrawn. They appear to be related more to limiting profitability and indirectly regulating lending practices than to risk retention, and would impose an undue economic burden on securitizations, potentially further limiting access to credit for many borrowers.

- We recommend that the term "par value" not be used in the credit risk retention rules. It serves no apparent purpose other than in the context of the premium capture provisions, which themselves should be removed from the rules.

- We believe that the proposed rules' definition of "credit risk" inappropriately includes changes in the market value of ABS interests, and we ask that this definition be corrected.

The Need for Clarification of Certain Aspects of the Proposed Rules

- The most important concepts underlying the proposed rules – particularly "par value," but also "ABS interest" – are unclear. Without a precise understanding of these key concepts, market participants cannot implement the proposed rules properly.

Risk Retention Options Could Be Much More Flexible, and Still Be Consistent with Congress's Objectives

- Permitting more flexibility in compliance with the credit risk retention rules would reduce the adverse impact of these regulations on securitization, without in any way reducing the "skin in the game" retained by securitizers. Below we outline several recommendations that we believe could be easily implemented and would not add undue complexity.

Forms of Risk Retention

- It is important that adjustments be made to the terms of the various forms of risk retention that have been proposed in order to permit the securitization markets to operate efficiently and economically. Below we propose several adjustments that we believe can be made in a manner that will permit clear disclosure to investors and regulators and will not introduce undue complexity.

Allocation of Risk Among Transaction Parties

- The proposed standards for allocation of credit risk retention to an originator are unnecessarily strict. These could be adjusted without adding undue complexity.

- The risk retention rules should permit proportionate allocation of retained credit risk between or among multiple sponsors of a securitization transaction.

The Qualified Asset Exemptions

- The proposed QRM eligibility criteria should be reexamined in light of their potential effects on the mortgage market and the economy, and re-proposed for comment.

- Final QRM standards should provide for realistic flexibility in loan underwriting such that strong positive factors can offset other factors.

- The servicing standards proposed for inclusion in QRM mortgage transaction documents are inappropriate and should be removed.

- The proposed exemptions from credit risk retention for qualifying commercial real estate loans, commercial loans and auto loans are unrealistically strict. In addition to making appropriate changes in the proposed lending criteria, the Agencies should adopt more realistic criteria to support a partial exemption from the risk retention requirements.

- These exemptions should not be all or nothing – credit risk should be required to be retained on a proportional basis to the extent that a securitized pool includes loans that are not qualified real estate mortgages or qualifying commercial real estate loans, commercial loans or auto loans (collectively, "Qualified Assets").

<u>Treatment of Fannie Mae and Freddie Mac</u>

- We support the proposed exemption of Fannie Mae and Freddie Mac from the risk retention requirements to the extent provided in the proposed rules. As we discuss below, there are other means available to transition the mortgage market toward more involvement by private capital and away from control by the Federal Government. It is not necessary or appropriate to impose a redundant level of risk retention on these institutions.

<u>Other Exemptions</u>

- The proposed rules should exempt tender option bond programs, repackagings of corporate debt and securitizations of Federal Family Education Loan Program loans from the credit risk retention requirements.

<u>Transactions Not Involving "Asset-Backed Securities"</u>

- We request clarification that full-recourse obligations that also have the benefit of financial assets pledged as collateral are not considered "asset-backed securities" under the Exchange Act.

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I. The Risk Retention Rules Should Be Part of a Holistic Approach to Regulation of the ABS Markets, Should Account for Differences in Types of ABS, and Should Avoid Excessive Vagueness or Complexity, and Therefore Require Significant Economic Analysis

These proposed rules are nothing short of monumental in their potential impact on the securitization markets and the availability of the consumer and commercial credit that fuels the U.S. economy. They must be carefully considered and implemented in a way that facilitates compliance and does not deter securitization.

The basic credit risk retention requirement reflected in the Dodd-Frank Act will, unavoidably, reshape the securitization markets in significant ways. But these effects may be magnified, depending upon how the statutory risk retention mandate is implemented by the Agencies. We are very concerned that the approach reflected in the proposed rules, whereby most asset classes are treated similarly and exemptions from risk retention are narrowly drawn, could have unintended consequences that would deter securitization and adversely impact the cost and availability of credit. Further, we are concerned that the proposed premium capture regime and the apparent but unpublished view of the Agencies that horizontal risk retention should have a market value of 5 percent of gross proceeds could damage the ABS markets if implemented without substantial change.

A. The Risk Retention Rules Should Be Considered in the Context of Other Significant Rulemakings and Potential Effects on Markets and Credit Availability

Although many aspects of the proposed rules clearly reflect careful analysis, certain aspects of the proposal appear not to have been fully considered. We recognize that the Dodd-Frank Act imposed a tight deadline for adoption by the Agencies of risk retention regulations, and that the Agencies used their best efforts to meet the deadline. However, the deadline has passed.[5] We urge the Agencies to take the time needed to get these regulations right. If necessary, we ask that the Agencies seek from Congress an extension of the statutory deadline for adoption of credit risk retention rules.

The proposed rules would impact every securitized asset class, and when finalized these rules will likely fundamentally reshape substantial portions of the securitization markets. We are concerned that the impact on certain asset classes would be extreme, and detrimental to borrowers and the broader economy. In particular, the commercial mortgage-backed securities (“CMBS”) and collateralized loan obligation (“CLO”) markets that provide vital financing to

[5] Section 941(b) of the Dodd-Frank Act directed the Agencies to jointly prescribe regulations governing credit risk retention by securitizers “not later than 270 days after the date of enactment.”

businesses would be adversely affected. The risk retention rules will also significantly impact residential mortgage securitization; we note that the debate over the qualified residential mortgage ("QRM") exemption has received deserved publicity and attention, as it will be central to the future of mortgage finance. Resecuritizations, which are important risk management tools, could be rendered uneconomical.

It is important that the costs of compliance with the risk retention rules be compared to and balanced with the benefits. The potential benefit to borrowers (both individual and corporate) from improvements to lending standards is clear, but should be balanced against the impact on the availability of credit of additional regulations. There is no disagreement that the adoption of the risk retention rules will, to an extent to be determined, generally increase the cost of credit. An economic and social analysis of these costs versus the benefits the regulations would confer, as recommended by the Chairman of the Financial Stability Oversight Council in a study of the macroeconomic effects of risk retention requirements mandated by the Dodd-Frank Act,[6] is imperative. We do not believe that the Proposing Release demonstrates that such an examination has occurred. For example, merely estimating that mortgage rates would increase for non-QRM loans by some number of basis points cannot be the end of the inquiry – we must determine what that means for borrowers, and how that will influence the financial markets in terms of demand for and availability of mortgage loans, housing, and housing related products, and ultimately the ability of residential mortgage loan securitizers to robustly produce transparent financing products that institutional investors, both domestically and globally, will want to buy. The same analysis is needed with respect to other asset classes.

This cost/benefit analysis and any broader discussion of the changes driven by the risk retention rules should be considered in the context of the interconnections among financial markets, financial market participants, consumers, and regulators. Major changes are occurring in other areas that affect each of these parties. For example, significant change is underway with respect to capital requirements and permitted activities of banks, and – of critical importance – to the future of Fannie Mae and Freddie Mac (the "GSEs") and the nature and scope of the Federal Government's involvement in housing finance. This is an era of uncertainty for financial market participants, businesses and consumers, from the sovereign level to the personal level.

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[6] *See* Timothy F. Geithner, Chairman, Financial Stability Oversight Council, Macroeconomic Effects of Risk Retention Requirements (January 2011) [hereinafter "Financial Stability Council Study"], at 18, available at http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20(FINAL).pdf, stating that"[a]s the Agencies promulgate regulations for risk retention as required by Section 941, they should seek to develop a framework that will balance the benefits of risk retention against its potential costs — incentivizing originators and securitizers to be conscious of the risk in the underlying assets that they are originating or distributing, while not unduly raising the cost of credit."

We cannot simply view the Agencies' adoption of final rules governing credit risk retention by securitizers as the end of the story. Risk retention standards interact with accounting and capital standards. Careful attention must be paid to how these standards interact – and the effects of those interactions must be considered in light of the goals of the Dodd-Frank Act and the Proposed Rules. Risk retention may impact the ability of lenders to securitize assets and move them off of their balance sheets, depending on the accounting treatment that is afforded. Capital may need to be held against retained assets – which could mean holding capital against only the 5 percent portion, or it could mean holding capital against the entire amount of the transaction, depending on the accounting treatment. Capital requirements may vary based on the form of risk retention and on the requirements imposed by the Agencies under each form of retention. These accounting standards and capital standards then will drive the capital allocation decision-making process. If securitization becomes overly capital-intensive without adequate returns, lenders will seek alternatives, to the great detriment of the credit markets.[7]

In addition, we ask that in the final rules, the Agencies commit to provide for a formal examination of the effects of the implementation of the rules on the cost and availability of consumer and commercial credit, including the ability of prospective home buyers to obtain mortgage financing, and on the various ABS markets, as well as the effects of retention of credit risk on the financial condition of financial institutions that are securitizers. All of this must be done in the context of the litany of regulatory changes related to securitization, capital, and financial markets more broadly. Put more simply, as of the writing of this letter, a large number of regulatory efforts are in progress or will soon be in progress. The regulatory community should have the responsibility to review how all of the disparate efforts fit together in the end, whether they have worked as intended, and how they have impacted end consumers of credit.

We recommend that this review be scheduled to take place one year after the effective date of the risk retention rules for RMBS, and again one year after the effective date for other asset classes.[8] Given the significance of this rulemaking, we believe it is important that the

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[7] As noted in the Federal Reserve Report, the interaction between accounting treatment and regulatory capital requirements "may have a significant effect on the cost and availability of credit. While it is possible that either capital or accounting standards could be adjusted, ex post, to remediate potentially negative consequences of risk retention requirements on credit availability, it also is true that such adjustments may not be made, or may not be made within the time that the credit risk retention requirements must go into effect." Federal Reserve Report at 84. *See generally* the discussion of this issue at pages 67-75 of the Federal Reserve Report.

[8] The Financial Stability Oversight Council (the "FSOC") could perform such a review, but the Dodd-Frank Act provides only for an FSOC study of risk retention before implementation of the rules, not after. We suggest that the Treasury Department could coordinate a review of the effects of implementation of the risk retention rules, and that the General Accounting Office may be an appropriate independent party to perform such a review.

Agencies carefully examine the effects of the rules and consider, in light of that examination, whether changes to the risk retention rules are appropriate.[9]

B. The Risk Retention Rules Should Accommodate Differences in Types of ABS

The Board of Governors of the Federal Reserve System, in its Report to the Congress on Risk Retention, found "considerable heterogeneity across asset classes in securitization chains, deal structure, and incentive alignment mechanisms in place before or after the financial crisis."[10] As a result, the report recommended:

> that rulemakers consider crafting credit risk retention requirements that are tailored to each major class of securitized assets. This approach is consistent with the flexibility provided in the statute and would recognize differences in market practices and conventions, which in many instances exist for sound reasons related to the inherent nature of the type of asset being securitized. Asset-class-specific requirements could also more directly address differences in the fundamental incentive problems characteristic of securitizations of each asset type, some of which became evident only during the crisis.[11]

Given the degree of heterogeneity in all aspects of securitization, the Federal Reserve concluded:

> a single approach to credit risk retention could curtail credit availability in certain sectors of the securitization market. A single universal approach would also not adequately take into consideration different forms of credit risk retention, which may differ by asset category. Further, such an approach is unlikely to be effective in achieving the stated aims of the statute across a broad spectrum of asset categories where securitization practices differ markedly.[12]

With limited exceptions, the proposed risk retention rules take a broad brush approach, prescribing risk retention requirements and permitting satisfaction of the requirements through any of several forms of retention that apply (for the most part) to each type of asset class without

[9] We believe that such a post-effective review would be consistent with the spirit of Executive Order 13563, issued by President Obama on January 18, 2011, which directs, among other things, that each federal agency develop a plan "under which the agency will periodically review its existing significant regulations to determine whether any such regulations should be modified, streamlined, expanded, or repealed so as to make the agency's regulatory program more effective or less burdensome in achieving the regulatory objectives."
[10] Federal Reserve Report at 3.
[11] Federal Reserve Report at 83.
[12] Federal Reserve Report at 83-84.

apparent consideration of the significant differences in asset classes. As proposed, the credit risk retention rules are a very blunt instrument, and could have serious, unintended consequences for the securitization markets and the U.S. economy generally.

It is by no means clear that the basic risk retention requirement prescribed for every asset class by the proposed rules – 5 per cent of the par value or fair value of each class of ABS interests or 5 percent of the par value of all ABS interests – is the appropriate baseline for all types of ABS. Section 941(b) of the Dodd-Frank Act mandates that the Agencies promulgate regulations that, subject to limitations and exceptions, require a securitizer to retain "an economic interest in a portion of the credit risk" for any securitized asset equal to "not less than 5 percent of the credit risk" for the asset.[13] The Agencies are also granted broad authority to provide for "a total or partial exemption of any securitization, as may be appropriate in the public interest and for the protection of investors."[14] We believe that for many types of ABS, 5 percent of the fair value or par value of the ABS interests may far exceed 5 percent of the credit risk associated with the securitized assets.

An example of a lack of consideration of the variation in securitization markets appears in the apparent conflation of the originate-to-distribute ("OTD") model, where mortgage loans are originated in order that they may be sold into secondary markets at a profit as a business model, and the originate-to-fund model, where loans are originated because that is the business of the lender, and securitization is the chosen funding strategy (versus other funding alternatives). SIFMA acknowledges the flaws and past abuse of the OTD model, and the damage it has caused financial markets. However, the Proposing Release takes a blunt approach to remediating problems with incentives in the OTD model and applies the same remedy to other markets which were not abused, to their detriment. The markets where poor practices caused the most significant problem are the residential mortgage-backed securities ("RMBS") markets and the associated mortgage-backed security collateralized debt obligation ("CDOs of MBS") market. CDOs of MBS primarily were backed by lower-quality RMBS. Credit rating downgrades were numerous in each of these markets, and collateral performance was poor in many cases.

However, other markets such as the CLO market, consumer ABS markets (*e.g.,* credit card and auto loan securitizations), multi-seller asset-backed commercial paper ("ABCP") and CMBS markets were not beset by such problems, and performed at a level that would be expected in the face of the severe recession that gripped the economy in recent years. We note that the consumer ABS markets have recovered in a manner that many market participants

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[13] §§ 15G(b)(1), (c)(1)(B)(i) of the Exchange Act.
[14] § 15G(c)(1)(G)(i) of the Exchange Act.

believe is nearly complete. The CMBS market has recently begun to get back on its feet, with increasing issuance volumes and investor appetite, and will be critical to the ability of companies to refinance the large amount of debt coming due over the next few years. Our originator, sponsor and dealer members are concerned that the activity in, and in some cases the viability of, the CLO, ABCP, and CMBS markets is materially threatened by the proposed rules, and that these markets will struggle to function if the rules are adopted as proposed.

For example, it is unlikely that the exemptions for qualifying commercial loans and commercial real estate loans will be used at all in CLO or CMBS transactions. In our view, the loans that would be exempted under these rules are not the sorts of loans that are, were, or likely ever will be securitized, for economic and other reasons. The number of existing securitized commercial loans that would satisfy the proposed criteria is close to zero. While we understand the Agencies' desire to limit exemptions to high quality assets, it is unclear that the CMBS or CLO markets suffered significantly from the practices that affected the RMBS market. We do not believe that all previous CLO and CMBS transactions, nearly all of the collateral for which would not be "qualified," are defective.

Similar to small mortgage lenders, most CLO managers will generally not be able to retain 5 percent of the credit risk of an entire transaction. Their role is that of an investment manager, and it is inappropriate to place the burden of retention on their shoulders, as compensation structures (among other things) already align their interests with those of CLO investors. Further, it is inappropriate to apply the proposed risk retention rules to CLOs generally, as we discuss further below.

As another example, ABCP conduit sponsors are not likely to be willing to disclose the identities of their customers. Companies that use ABCP conduits for funding are not likely to desire that their funding strategies be exposed in this manner. In addition, customer identity is irrelevant to the conduit investor, to whom the reputation of the sponsor and creditworthiness of the liquidity provider are of far greater interest.

It is unclear why the viability of these markets should be threatened, and the credit costs of the ultimate borrowers should be raised, because regulators are trying to fix the problems of the residential mortgage securitization market. Our originator, sponsor and dealer members believe that the proposed risk retention rules should be tailored to the specific risks and realities of distinct asset classes.

C. The Risk Retention Rules Should Be Clear and Not Unnecessarily Complex

Among the core principles identified by the Chairman of the Financial Stability Oversight Council in a study of the Macroeconomic Effects of Risk Retention is that rules governing credit risk retention should "[p]rovide greater certainty and confidence among market participants. A risk retention framework that provides clear rules," the Council Study stated, "can help market participants accurately price risk."[15]

Unfortunately, the proposed credit risk retention rules are far from clear. Putting aside our deeply felt concerns about the appropriateness of some of the proposals, it would not be possible for a sponsor to follow the rules as written. As we discuss elsewhere, key concepts are undefined and unexplained, and in some respects the rules layer complexity atop ambiguity. We appreciate the difficulty of the task that has been handed to the Agencies by Congress. Our members are participants in the capital markets and appreciate the challenges posed by the task of developing a coherent set of risk retention rules. Nevertheless, clarity is vital, and we urge the Agencies to move toward a more straightforward risk retention regime.

Elimination of the premium capture provisions and the concept of synthetic par value will greatly aid the Agencies in developing more straightforward rules.

The importance of simplicity and clarity is highlighted by the likely difficulty that securitization sponsors will have in obtaining regulatory clarification after the risk retention rules are adopted. Seeking guidance from a regulator can be a challenge even under ordinary circumstances. Agency staff are sometimes understandably reluctant to express a view without first carefully analyzing an applicant's request and considering alternative interpretations. A request for clarification or a "no-action" position can take weeks or months to resolve even when the rules in question are far more straightforward than the credit risk retention rules. In this case, market participants are confronted by a joint rulemaking that, as the Agencies stated in the Proposing Release, will require that the appropriate Agencies "jointly approve any written interpretations, written responses to requests for no-action letters and legal opinions, or other written interpretive guidance concerning the scope or terms of section 15G and the final rules issued thereunder that are intended to be relied on by the public generally."[16] Further, "the appropriate Agencies will jointly approve any exemptions, exceptions, or adjustments to the final rules."[17]

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[15] Financial Stability Council Study at 18.
[16] Proposing Release, 76 Fed. Reg. 24090 at 24097.
[17] *Id.*

A large number of requests for interpretive guidance, clarifications and exceptions following the release of the final credit risk retention rules would be a burden that we are confident the Agencies would wish to avoid. We ask that the Agencies make an effort to produce a second set of proposed rules, and then, ultimately, final rules, that will be as easy as possible for those subject to them to understand and follow, and of course for the Agencies to monitor and enforce.

D. Risk Retention Requirement Should Be Reduced Over Time

1. Risk Retention Requirement Should Be Reduced as the Securitized Pool Amortizes

Depending upon how an eligible horizontal residual interest is structured, it may not amortize at the same rate as the more senior ABS interests. If there are few or no losses on the pool assets, an eligible horizontal residual interest could actually increase over time as a proportion of all ABS interests. Securitizers should not be required to continue to retain an eligible horizontal residual interest in excess of 5 percent of the aggregate of the ABS interests, and we ask that this be made clear in the risk retention rules. To the extent that a retained horizontal interest exceeds the 5 percent threshold as expressed in the final rules, we ask that the sponsor or other retaining party be permitted to transfer or directly hedge such excess interest.

2. Risk Retention Requirement Should Terminate After a Reasonable Time

We believe that the alignment of interests between securitizers and investors that Congress and the Agencies seek to achieve through mandatory risk retention can be achieved by requiring that a sponsor (or other party)[18] retain the required risk exposure for a limited period of time following origination of the pool assets. We recommend that the risk retention requirement terminate no later than three years after the date of origination of the least seasoned asset in the securitized pool.

The performance of the pool assets over time will demonstrate whether risk retention met its goal of aligning interests and promoting sound securitization structures. Analyses of historical performance data for various loan types demonstrate that losses attributable to faulty origination practices generally occur in the earlier months following origination.

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[18] § __.14(a) of the proposed rules would prohibit a sponsor from transferring any credit risk the sponsor was required to retain under the risk retention rules, other than to a consolidated affiliate. Originators, ABCP originator-sellers and CMBS B-piece buyers would be bound by this same limitation under the terms of §§ __.14

Payment performance, of course, will vary by asset class and by credit grade within an asset class. We readily concede that three years is an arbitrarily selected time period, and that shorter periods could reasonably be proposed for some asset classes, such as auto loans. However, we are mindful of the Agencies' concern that the credit risk retention rules not be made so complex that they are cumbersome to monitor and enforce. We believe that three years is a sufficiently long period of time such that even in the case of long-term assets such as residential mortgage loans, it will generally be evident by the end of that period whether the credit decision contributed to the rate of delinquency and default on the pool assets. After three years, losses on pool assets generally will be attributable to factors other than the origination process, such as changes in borrowers' circumstances or market factors. We strongly believe that risk retention rules were primarily intended by Congress to prevent defective and careless origination of credit. To the extent that assets in a securitization transaction incur losses as a result of changes in broader economic conditions, such as regional economic downturns that cannot be foreseen by credit originators, these losses should not be the responsibility of the securitization sponsor to incur. Rather, they are exactly the type of risk that all investors in all types of investments are exposed to, and there is no reason to single out securitization as unique among these various investments.

In addition, we urge the Agencies to consider the potential adverse consequences for financial institutions that would be compelled to hold unhedged risk positions for an indefinite period of time that may, in some cases, be as long as 40 years. We believe that it is appropriate to balance the interests of a financial institution that is holding this unhedged exposure versus interests of investors. For a securitizer that is a financial institution, continuing to hold an increasing portfolio of unhedged securitization risk exposures for an indefinite period could raise significant safety and soundness concerns. Further, as a practical matter, a securitizer's balance sheet may be unable to accommodate further risk retention, for reasons such as reaching risk limits,[19] forcing the institution to abandon securitization as a financing strategy for at least a period of time.

We ask the Agencies to limit the mandatory retention of credit risk to a period of three years. This limitation would be consistent with the goals of Section 15G of the Exchange Act in promoting quality underwriting and investor protection, while also recognizing important considerations of safety and soundness of financial institutions.

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[19] Note that these limits could be lower than those for assets for which the entity is not required to retain credit risk, due to the prohibitions on hedging of retained credit risk.

E. It Is Not Possible to Comment Adequately on the Risk Retention Rules as Proposed

As we noted in our letter to the Agencies on April 21, 2011,[20] representatives of SIFMA have had discussions with representatives of certain of the Agencies in which we have sought to better understand certain aspects of the proposed rules in order to craft a useful response. During these discussions it became apparent to us that the Agencies' intent may not, in critical respects, be fully and accurately reflected in the proposed rules and the accompanying supplementary information. In particular, it is not clear from the text of the proposed rules and accompanying commentary how the premium capture provisions are intended to operate. In addition, the key concept of "par value" is not defined in the proposed rules or explained in the accompanying commentary. As we discuss below, we believe that the Agencies' conception of par value as used in the proposed rules may be very different from the commonly understood meaning of that term, and that the Agencies' view in this regard is key to understanding the effect of the premium capture provisions. But precisely what the Agencies intend in this regard is not clear.

An accurate understanding of these concepts is vital to an understanding of the proposed rules.

Other core concepts also need to be clarified. For example, as we discuss below, the scope of "ABS interest" is unclear.

We at SIFMA have had the benefit of conversations with representatives of certain of the Agencies, for which we are very appreciative. We have endeavored to share that information with our members. However, many market participants and other parties that will be affected by this highly consequential rulemaking have not had the same opportunity, and may be unaware of the fundamental ambiguities in the proposed risk retention regime or have only a partial understanding based on press reports or conversations with others in the market. It would be unfair to our members, and even more so to other market participants and to individuals and businesses that rely on the availability of credit that is facilitated by securitization, to impose final credit risk retention rules without providing an adequate opportunity for public comment.

We urge the Agencies to take the time needed to carefully consider this letter and the other comments that are received, reevaluate the proposed rules, undertake a risk/benefit analysis that considers the broad ramifications of the risk retention requirements, and republish the rules in proposed form in order to provide a fair and reasonable opportunity for public comment.

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[20] *Available at* http://www.sec.gov/comments/s7-14-11/s71411-16.pdf.

II. It Is Unclear How Risk Retention Is to Be Measured Under the Proposed Rules

We are concerned that the common understanding of the concept of credit risk retention is not reflected in the proposed rules, either as the proposal is written or as we believe its provisions are intended to be interpreted. The Agencies appear to intend an application of the premium capture provisions and a "market value" approach to par value and horizontal risk retention that would inappropriately interfere with securitization structures and would result in risk retention requirements far beyond the scope of Section 941(b) of the Dodd-Frank Act.

A. Par Value vs. Market Value vs. Gross Proceeds: What We Believe the Agencies Intend

Based upon conversations with representatives of certain of the Agencies, information disseminated to certain parties by the Federal Reserve Bank of New York (the "FRBNY"),[21] and careful examination of the proposed rules and the accompanying commentary:

- We believe that the Agencies intend for the premium capture provisions to eliminate premium realization at the closing of a securitization of premium assets by forcing into the residual interest excess interest cash flows beyond what is needed for credit enhancement of the more senior classes of ABS.

- We believe that the Agencies intend that the total par value of the ABS interests in an issuing entity equal their market value (or the market value of the securitized assets).

- We believe that the Agencies intend that the residual interest must have a market value equal to 5 percent of the market value of all ABS interests in the issuing entity, without regard to its par value, and that this could result in horizontal risk retention in an amount far greater than 5 percent of the credit risk of the securitized assets.

- Further, we believe that the Agencies intend this outcome even when a sponsor satisfies its risk retention requirements through a method other than retention of the residual interest.

- In addition, we believe that the Agencies intend that the proposed premium capture provisions, together with a market value calculation of par value, would operate to

[21] We refer to a presentation dated April 7, 2011, titled "Federal Reserve Bank of New York: Understanding Premium Capture," prepared by an officer of the FRBNY. Although this material was not to our knowledge disseminated publicly by the FRBNY, it has been made widely available. We recognize that this information is labeled as reflecting only the views of the author and may not reflect the views of the FRBNY or the other Agencies.

reduce the proceeds of securitization of discount pools by increasing the value of the residual interest.

In the Proposing Release, the Agencies explained:

> In many securitization transactions, particularly those involving residential and commercial mortgages, conducted prior to the financial crisis, sponsors sold premium or interest-only tranches in the issuing entity to investors, as well as more traditional obligations that paid both principal and interest received on the underlying assets. By selling premium or interest-only tranches, sponsors could thereby monetize at the inception of a securitization transaction the "excess spread" that was expected to be generated by the securitized assets over time. By monetizing excess spread before the performance of the securitized assets could be observed and unexpected losses realized, sponsors were able to reduce the impact of any economic interest they may have retained in the outcome of the transaction and in the credit quality of the assets they securitized. This created incentives to maximize securitization scale and complexity, and encouraged aggressive underwriting.[22]

The Agencies went on to state that they "propose to adjust the required amount of risk retention to account for any excess spread that is monetized at the closing of a securitization transaction. Otherwise, a sponsor could effectively negate or reduce the economic exposure it is required to retain under the proposed rules."[23]

We believe the idea that monetization of excess spread through the issuance of interest-only or other premium securities senior in priority to the residual interest would reduce or negate the economic impact of a sponsor's retained risk exposure is a fundamentally false premise. In some securitization transactions, excess spread is a significant component of the value of the residual interest; in some it is not. We believe that the Agencies should be indifferent, so long as an amount of risk retention that represents at least 5 percent of the credit risk in the pool assets is retained. The sale by a securitization sponsor of premium securities, and the realization thereby of premium proceeds, would in no way diminish the economic integrity of a properly structured eligible horizontal residual interest. In our view, the Agencies' concern in this regard should be limited to ensuring that the residual interest, if the sponsor intends to satisfy its risk retention obligations through horizontal retention, is not inappropriately stripped of its proportionate economic entitlement, not that the value of the residual interest be artificially increased or that

[22] Proposing Release, 76 Fed. Reg. 24090 at 24113.
[23] *Id.*

the profitability of securitizations be limited (other than, of course, to the extent to which the basic risk retention requirement itself unavoidably limits profitability).[24]

B. Specific Concerns Regarding the Proposed Rules' Measurement of Credit Risk

The proposed rules provide that, under the basic vertical and horizontal forms of risk retention, a sponsor must retain either not less than 5 percent of each class of ABS interests in the issuing entity (vertical) or an eligible horizontal residual interest in an amount equal to at least 5 percent of the "par value" of all ABS interests in the issuing entity (horizontal). Each other form of risk retention provided for in the proposed rules – other than the seller's interest in a revolving master trust or a representative sample of the pool assets, which are based on different calculations – is a variant of these two basic mechanisms.

1. The Vertical Risk Retention Requirement Is Expressed in a Reasonable Manner and Does Not Rely on "Par Value"

In the commentary accompanying the proposed rules, the Agencies state that for vertical risk retention the proposed rules "do not specify a method of measuring the amount of each class, because the amount retained, regardless of method of measurement, should equal at least five percent of the par value (if any), fair value, and number of shares or units of each class."[25] This implies that measurement on the basis of "par value" or "fair value" could yield different results in the case of some or all of the ABS interests, depending upon how they are structured. If so, then the sponsor would be required to retain a portion of each ABS interest equal to the greater of par value or fair value.

This approach appears intended to prevent abusive structures designed to circumvent the risk retention rules, and we believe that this approach should work in practice. It is not unreasonable to require that a sponsor retain 5 percent of the fair value or market value of each

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[24] Before the financial crisis there were transactions – generally referred to as net interest margin, or "NIM," securitizations – in which sponsors did monetize excess spread generated by residual interests in securitizations of residential mortgage loans. These transactions do not appear to be the sort of structures at which the Agencies have aimed the premium capture provisions. In almost every case NIM securitizations were separate transactions from the mortgage loan securitization in which the residual interest was issued. Generally, a separate issuing entity would acquire the residual interest and pledge it to secure payment on notes issued by the NIM issuing entity. The notes were issued in synthetic principal amounts supported by residual interest cash flows. If the Agencies want sponsors not to use NIM securitizations or similar structures to monetize excess spread embedded in an eligible horizontal residual interest, such practices could easily be prevented under §__.14 of the proposed rules, which is intended to prohibit the sponsor and its consolidated affiliates from transferring the retained risk position or pledging it to secure a financing other than a full recourse financing.

[25] Proposing Release, 76 Fed. Reg. 24090 at 24101.

class of ABS interests because the measurement of what is required to be retained is made on a class-by-class basis, not on the basis of the comparative values of different classes of ABS interests. This stands in contrast to the measurement framework that we believe has been proposed for horizontal risk retention, discussed below.

2. Other Risk Retention Options Rely on "Par Value," Which Is Undefined But May Be Intended to Mean "Market Value"

Although an understanding of "par value" is essential to calculating risk retention under the horizontal, L-shaped, ABCP originator-seller and CMBS B-piece buyer methods of risk retention and to understanding the operation of the premium capture provisions, the term "par value" is not defined in the proposed rules or explained elsewhere in the Proposing Release.

We generally understand "par value" in the context of ABS and other fixed income securities to refer to the face amount, stated amount, or principal amount owed in respect of a security. Typically, ABS are said to trade at a premium or discount to "par" if the market price of those securities is greater or less than 100 percent of their principal amount. Calculation of risk retention on the basis of principal amount would be a sensible approach to retention under the horizontal, L-shaped, ABCP originator-seller and CMBS B-piece buyer methods, and would be consistent with the approach taken by the European Union in Article 122a of the Capital Requirements Directive.[26]

However, the Agencies appear to have a different view of "par value" as an amount that is calculated by reference to the market value of the pool assets or ABS interests. We believe the Agencies intend that, under the risk retention rules, ABS issued in any securitization transaction would have an artificial or synthetic "par value" calculated on the basis of the estimated market value of the securitized assets or of the ABS interests issued in the securitization. Precisely how this calculation would be performed is not addressed in the proposed rules or the accompanying commentary and remains unclear to us. However, in the case of a "premium" pool – a pool of financial assets whose securitization would generate proceeds (or deemed proceeds) in excess of 100 percent of the total principal amount of the pool assets – the Agencies appear to expect that the par value of the residual interest would be increased so that the ABS interests would be issued in a total par value in excess of the total principal amount of the pool assets. [27]

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[26] *See* Community of European Banking Supervisors, Guidelines to Article 122a of the Capital Requirements Directive (Dec. 31, 2010) [hereinafter "CEBS Guidelines"].

[27] We believe that using this interpretation of "par value" to implement the premium capture provisions, as discussed below, would be fatal to many securitization transactions. Those deals simply would not be economical if the sponsor were forced to subordinate premium proceeds.

We do not believe that this synthetic par value scheme would work in practice. Most importantly, we believe that much of the securitization market could cease to function if the risk retention rules were to require that an eligible horizontal residual interest retained by a sponsor (or other party) must be in an amount equal to 5 percent of the gross proceeds of a securitization.

3. Synthetic Par Value Approach Would Pose Difficult Structuring Challenges

The use of a market value approach to "par value" in calculating risk retention would result in residual interests with complicated characteristics not driven by economic rationales, creating difficult structuring challenges. We illustrate this concern by addressing how securitizations of both "premium" and "discount" pools might be structured.

Securitization of a "Premium" Pool. In general, any premium generated by the sale of ABS issued in a typical securitization transaction would be based on the value assigned by investors to above-market interest rates on the pool assets. Theoretically, this value could be realized by issuing ABS with above-market coupons, but in practice fixed income investors tend to prefer ABS priced at or close to par – at least in the case of securities that are relatively senior in payment priority and are believed to be of relatively high credit quality. Therefore, premium typically would be realized through the structuring and sale of one or more interest-only securities for sale to investors that are willing to purchase exposure to the related prepayment risk and believe they are able to effectively evaluate and price that risk.

However, the Agencies may instead contemplate the issuance of ABS interests having a total "par value" in excess of the total principal amount of pool assets. This would appear to require the issuance of ABS interests – or at least, a residual interest – having a synthetic par value calculated based upon expected excess interest cash flow. We refer to an FRBNY example which states that where a loan pool "originated at above-market interest rates" has a "market value of $102," which is "more than [the] unpaid principal balance of $100," the sponsor could structure a "simple senior-subordinate transaction so that it sells or retains $102 of claims to principal (par value)."

If a sponsor structures and sells or retains "claims to principal" in excess of the total principal amount of the underlying pool assets, the additional amount – $2, in the above example – is not actually supported by any principal at all. It can only be based upon expected excess interest cash flows that are expressed as a principal amount, or par value. There would not be a one-to-one relationship between the principal amount of the pool assets and the ABS issued, so that it is not clear, for example, how the par value of the ABS interests would be reduced as principal losses are realized on the pool assets. (We note that an eligible horizontal residual interest must be "allocated all losses on the securitized assets" until "the par value of such ABS

interest is reduced to zero."[28]) A rate of prepayments higher than anticipated could reduce or eliminate the excess interest cash flows that would have supported the issuance of excess "par value," but the excess par value would not amortize as a result.

Securitization of "Discount" Pools. Another FRBNY example describes a hypothetical transaction in which a loan pool was "originated at below-market interest rates so [the] market value of $95 is less than [the] unpaid principal balance of $100." In this case, according to the FRBNY, the sponsor could structure "a simple senior-subordinate transaction so that it sells or retains $95 of claims to principal (par value)." In this example the issuing entity issues notes having a par value of $90.25 and a residual interest having a par value (and market value) of $4.75.

It is not clear to us how the Agencies intend that sponsors would structure securitizations of discount pools in compliance with the premium capture rules. A sponsor could issue senior ABS interests having a total principal amount equal to less than the total principal amount of the underlying loans, with interest collection on the entire $100 of pool assets being applied to support a market-level interest rates on the $95 of ABS interests.[29] In such a transaction the residual interest would presumably be entitled to any principal collected on the underlying loans in excess of the $95 par value of the ABS interests. It is not clear, however, how principal losses incurred on the $100 of pool assets would be allocated to reduce the $95 par value of the ABS interests. It appears to us that in this example a sponsor that retains an eligible horizontal residual interest would be effectively retaining credit risk of 9.75 percent. The residual interest would have a par value of $4.75 and would also be entitled to, and therefore would bear the risk of loss of, the additional $5 of pool assets not represented by the par value of the ABS interests.

Alternatively, the Agencies might intend that the $5 of pool assets not represented by the par value of the ABS interests would be applied to pay interest on the ABS interests, but again it is not clear how principal losses on the pool assets would be allocated to reduce the par value of the ABS interests.

Securitization of Premium or Discount Pools in REMIC Transactions. Most residential and commercial mortgage-backed securities are issued in the form of pass-through certificates that are classified for federal income tax purposes as "regular interests" in a real estate mortgage investment conduit, or REMIC. Congress added the REMIC provisions to the income tax code as part of the Tax Reform Act of 1986 (the "Tax Reform Act") in order to facilitate securitization

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[28] Proposing Release, 76 Fed. Reg. 24090 at 24157.

[29] We note that this result could be accomplished by issuing a $5 principal-only class of ABS interests rather than discounting the par value of ABS interests to $95.

of mortgage loans.[30] In general, an issuing entity or portion thereof that qualifies to and does elect REMIC status is not subject to entity-level taxation. Each REMIC may issue an unlimited number of regular interests and must issue a single class designated as the residual interest. Each REMIC must compute taxable income (or loss) each year, and each holder of the residual interest in a REMIC must include in its taxable income its *pro rata* share of the REMIC's income or loss.[31] Although a REMIC residual interest may in some transactions be entitled to receive cash flow, in most mortgage securitizations the REMIC residual is structured so that it is "noneconomic" – the REMIC residual is not entitled under the transaction documents to receive any cash flows.[32] (Even though a REMIC residual interest may be structured so that it is not entitled to receive distributions, the residual interest may produce income for federal income tax purposes. This result was intended by the Tax Reform Act.)

Premium Pools in REMICs. Our concerns regarding application of the premium capture provisions and a "fair value" concept of par value to REMIC transactions can be illustrated in the context of an example which assumes that a pool of mortgage loans has a total unpaid principal balance of $100 and a market value of $102, and that ABS interests are issued in a total par value of $102.

Section 860D(a)(2)[33] requires that all of the interests in a REMIC be either regular interests or residual interests.[34] Thus, if any security issued in this example does not meet the rules for regular or residual interests, the transaction contemplated by the example will fail to qualify as a REMIC. Treasury Regulation Section 1.860D-1(b) provides that certain *de minimis*

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[30] We have not undertaken a detailed discussion of the REMIC provisions in this letter.

[31] A holder of a REMIC residual interest may in some cases recognize taxable income in the earlier years of the REMIC's life and taxable losses in later years, even if the residual interest is not expected to receive any cash distributions. The residual interest may therefore have a negative net present value, as the holder generally will be required to pay income tax in the early years of a REMIC's life and not be entitled to any losses until the later years of the REMIC. Many securitization sponsors do not retain residual interests. Rather, sponsors often sell them to qualified transferees; in many cases the purchaser of a REMIC residual interest is paid an inducement payment by the sponsor to accept the transfer. Transferees of REMIC residual interests must generally be domestic taxable corporations that satisfy certain minimum gross and net asset standards and make certain representations. Congress and the Internal Revenue Service have restricted the transferability of REMIC residual interests in order to ensure that these residual interests are owned by parties that are able and wiling to satisfy the related income tax liabilities. In our experience there is a limited market for REMIC residual interests.

[32] As a technical matter, a REMIC residual interest must be entitled to receive any cash remaining in the REMIC after all regular interests have been retired. But in practice REMICs are frequently structured so that no cash remains after payment of the regular interests.

[33] Unless otherwise noted, all references herein to a "Section" are to sections of the Internal Revenue Code of 1986, as amended.

[34] Regular interests in a REMIC, which are the interests that are generally sold to most investors, are taxable as debt of the REMIC, and are familiar to investors in mortgage-backed securities.

interests (generally having a value no greater than $1,000) and certain specified rights are not treated as "interests" in a REMIC. Given the limited scope of these exceptions, REMIC sponsors closely adhere to the requirements for regular and residual interests to avoid creating any non-permitted interests.

Because the example contemplates that ABS interests would be issued in a par value of $102, either one or more REMIC regular interests or the REMIC residual interest must be issued in a par value representing, at least in part, an amount in excess of the total principal balance of the underlying mortgage loans. We understand that the premium capture provisions are intended to force excess spread into the residual interest. However, in the context of a typical REMIC securitization it is important to distinguish between the "economic" residual, which is issued in the form of one or more REMIC regular interests and is entitled to excess cashflow; and the REMIC residual interest, which is generally not entitled to any cash flow and is therefore referred to as "noneconomic." Due to the unique tax characteristics associated with REMIC residual interests they cannot be sold to most ABS investors, and REMIC residuals are frequently not retained by sponsors. In virtually all REMIC securitizations, therefore, any so-called "residual" interest that is entitled to a material amount of excess cash flow is structured in the form of regular, rather than residual, interests in the REMIC. [35]

Issuing regular interests with a total principal amount greater than the total principal balance of the loans, $100, would be problematic. Under Section 860G(a)(1)(A) and Treasury Regulation Section 1.860G-1(a)(5), a regular interest (unless it is an interest-only security[36]) must unconditionally entitle the holder to receive the principal amount of the regular interest. Treasury Regulation Section 1.860G-1(a)(5) provides additional guidance regarding the requirement that the principal amount of a regular interest be "unconditionally payable." It provides that, except for certain specified circumstances, the principal amount of a regular interest cannot be contingent. The permitted contingencies include such items as credit losses on the mortgage loans and unanticipated expenses of the REMIC. In the example, the $2 premium reflects additional market value but this premium cannot be captured in a way that will support the issuance of REMIC regular interests with an additional par value (principal amount) of $2. The additional $2 of principal cannot be paid from principal on the mortgage loans as only $100

[35] In mortgage securitizations, a "residual" interest that is entitled to significant cash flow is generally structured as one or more interest-only REMIC regular interests.

[36] Not all REMIC regular interests are required to have principal amounts. Section 860G(a)(1)(B)(ii) provides that a regular interest can receive interest payments consisting of a "specified portion" of the interest payable on qualified mortgages held by the REMIC. In such a case, Treasury Regulation 1.860G-1(a)(2)(iv) specifies that no principal amount is required. Accordingly, in the example, an interest-only ("IO") regular interest could be issued to capture the $2 premium, but of course the premium capture provisions would operate to discourage issuance of IO interests.

of principal is owed on the mortgage loans, and all the principal due on the mortgage loans will be paid to other regular interest holders.

In addition, using interest due on the mortgage loans to satisfy an additional $2 par value (principal amount) of regular interests would be problematic as well. Importantly, Treasury Regulation Section 1.860G-1(b)(3)(i)(A) states that an interest does not fail to be a regular interest solely "because the timing of (but not the right to or amount of) principal payments" is affected by the extent of prepayments on some or all of the mortgages held by the REMIC. The parenthetical in the regulation quoted in the preceding sentence generally will preclude a REMIC from issuing a regular interest whose principal amount is expected to be retired from interest payments on prepayable mortgage loans. Typically, residential mortgage loans are prepayable at any time (and such prepayments do not always require the payment of a prepayment penalty). As a result, relying on interest payments to satisfy the additional $2 par value (principal amount) would raise a serious concern that the payment of this $2 was subject to a contingency not contemplated by the REMIC rules.

Although Treasury Regulation Section 1.860G-1(b)(3)(vi) provides an exception for a contingency "if there is only a remote likelihood" that the contingency would occur, there is no guidance providing that the exception would apply in this case. The only guidance on point is an example concluding that an interest could qualify as a regular interest even though full payment of principal or interest is contingent upon the "absence of significant cash flow shortfalls due to the operation of the Soldiers and Sailors Civil Relief Act." Extrapolating from this example to conclude that the likelihood of not paying the principal amount of a regular interest solely from interest on prepayable loans was remote, particularly in light of the express language of the parenthetical cited above seemingly prohibiting a REMIC from issuing such a regular interest, seems a risky challenge for any REMIC sponsor. To be clear, if the sponsor is wrong, the transaction will fail to qualify as a REMIC, and the issuing entity could be subject to entity-level taxation.

In the example described above, the additional $2 par value in excess of the principal balance of the underlying mortgage loans could be ascribed to the residual interest, because the balance of a residual interest is not required to be "unconditionally payable." Treasury Regulation Section 1.860G-1(c) provides that a residual interest is an interest in a REMIC that is issued on the startup day and is designated as such. Treasury Regulation Section 1.860G-1(c) also confirms that a residual interest need not entitle the holder thereof to any distributions. Accordingly, the residual interest could be issued with a $2 par value even though that amount could never be paid from principal collections on the mortgage loans. However, issuing the residual interest with a par value of $2 would not create a principal amount that could actually absorb $2 of principal losses. This is because there would be no principal cash flow payable to

the residual interest that could be diverted to cover the loss. For example, if a $1 loss of principal is incurred on the mortgage loans and the par value of the residual interest is reduced by $1 (as contemplated by the proposed rules), there would remain a pool of loans with a principal amount of $99 and regular interests outstanding with a par value (and principal amount) of $100. A regular interest holder ultimately would bear the $1 of principal loss, as the principal balance of the remaining collateral could only retire $99 of the par value (principal amount) of the regular interests.

The residual interest could be entitled to receive the interest payments on the mortgage loans in excess of the amount needed to pay current interest due on the regular interests. However, as noted above REMIC residual interests are not typically entitled to material cash flows. In order to retain all or a portion of a REMIC residual interest having those economics, a sponsor would need to suffer the adverse tax consequences typically associated with REMIC residual interests. A sponsor retaining a vertical slice of ABS interests would be required to retain a portion of such a REMIC residual and, to the extent that a REMIC residual interest has the most subordinated claim to principal and interest, a sponsor retaining an eligible horizontal residual interest would be required to retain the entire REMIC residual interest.

Discount Pools in REMICs. Different issues arise with a discount pool. Assume instead that the pool of loans has an unpaid principal balance of $100 and a market value of $95. If ABS interests can be issued in a par value of only $95, then regular interests could be issued in a par value of $90.25 and a REMIC residual interest could be issued in a par value of $4.75. The regular interests would be entitled to an amount of principal equal to their par value.[37] The REMIC rules would require that the residual interest be entitled to receive any additional principal collections on the mortgage loans in excess of the total par value of the regular and residual interests. The REMIC residual interest would therefore bear the risk of loss of the additional $5 of pool assets not represented by the par value of the ABS interests. The sponsor would be compelled under the proposed rules to retain all or a portion of the REMIC residual and bear the associated tax consequences.

[37] The REMIC rules would not seem to allow paying the additional $5 as part of the interest entitlement of the regular interests. Under Section 860G(a)(1)(B), interest can be paid on a regular interest under one of two rules. First, a regular interest can bear interest at a fixed rate or at a variable rate specified in Treasury Regulation Section 1.860G-1(a)(3). Under this rule, the additional $5 does not seem capable of being expressed as either a fixed rate or permitted variable rate, as it is an absolute dollar amount that is not measured by the passage of time (that is, it doesn't increase the longer the related security remains outstanding) and is not payable by reference to any particular outstanding balance. Second, interest payments on a regular interest can consist of a "specified portion" of the interest payable on qualified mortgages held by the REMIC. In the example, however, the additional $5 is payable in the form of principal, not interest.

As noted above, it is not clear how principal losses incurred on the $5 of pool assets not represented by the par value of the regular or residual interests would be allocated to reduce the par value of the residual interest.

4. Impact of "Market Value" Interpretation on the Economics of Horizontal Risk Retention

Our conversations with representatives of certain of the Agencies, information disseminated to certain parties by the FRBNY, and careful examination of the proposed rules and the accompanying commentary lead us to believe that the Agencies intend that an eligible horizontal residual interest equal to at least 5 percent of the par value of all ABS interests in the issuing entity should – or must – have a *market value* equal to at least 5 percent of the value of the pool assets and/or 5 percent of the theoretical gross proceeds that would be generated by sale of all of the ABS interests.

Based upon discussions with representatives of certain of the Agencies,[38] we understand that the premium capture provisions are intended to force changes in securitization structures to the extent necessary to ensure that the first loss position is equal to at least 5 percent of total market value. The FRBNY presentation referred to above, in one example, states that "[t]he premium capture condition limits proceeds to 95 percent of the par value of the ABS interests in the loan pool, *which ensures the first loss position has market value equal to its par value.*" (emphasis added) Another FRBNY example shows a residual interest having a par value of $7 but a market value of $5.1, and states that "the market value of the first loss position is a discount to its par value, *but it has value equal to five percent of the market value of the loan pool*." (emphasis added) Further, the premium capture provisions themselves appear to embody this concept that the retained horizontal residual interest should have a value equal to 5 percent of gross proceeds. § __.12 of the proposed rules provides for calculation of the amount of a premium capture reserve account on the basis of the amount by which gross proceeds (net of certain expenses) exceed 95 percent of the par value of the ABS interests (or 100 percent if credit risk is not in the form of ABS interests retained by the sponsor). Read in conjunction with our understanding of the Agencies' view of "par value," the premium capture formula implies that the risk exposure retained by the sponsor would have a value of 5 percent of gross proceeds.

Such an approach to regulation of the ABS markets would have a harsh impact on securitizers, rendering many securitizations uneconomical.

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[38] We recognize that these conversations have been informal and that the views expressed may not be those of the Agencies. However, the same message has been communicated repeatedly, and as we explain below the structure of the premium capture provisions supports the conclusion that this may in fact be the Agencies' view.

Risk retention is not a foreign concept in the capital markets. Retention of 5 percent of the credit risk associated with an asset means, at most,[39] retention of 5 percent of the risk of loss if the amount owed is not repaid. If a lender lends money to a borrower, the lender's credit risk is the risk that the borrower does not repay the amount owed, with interest, when it is due. This risk is not directly related to whether changes in market interest rates or other factors may increase or decrease the market value of the loan.

Long before securitization began, whole loans were sold between institutional sellers and purchasers. It was sometimes the case, and it still is the case in some whole loan sales, that a seller would retain limited risk of loss associated with the loans. In securitization transactions, the initial risk of loss associated with the pool assets is commonly borne by one or more classes of subordinated interests. The amount of credit risk associated with each of these subordinated interests is equal to the maximum amount of losses than can be incurred until the amount of such subordinated interest is reduced to zero. The market value of an ABS interest may be affected by changes in the credit performance of the pool assets, but this means only that market value has been affected by a perceived increase in credit risk – not that the change in market value itself is "credit risk" of the type contemplated by Section 15G of the Exchange Act. Mere changes in the market value of a loan, an asset-backed security, or any instrument do not affect the amount owed thereunder or influence whether that amount will be repaid by the obligor.

<u>Examples</u>.[40] Assume that a sponsor holds a pool of $100 million of performing loans bearing market interest rates. The hypothetical sponsor might structure a securitization in which notes having a total principal amount of $95 million are issued and sold to investors, and an eligible horizontal residual interest having a principal amount of $5 million is issued and retained by the sponsor. In this example, it is clear that the residual interest represents 5 percent of the maximum theoretical credit risk,[41] and has been issued in an amount that represents 5 percent of the value of the pool assets. However, this residual interest is almost surely not worth 5 percent of theoretical gross proceeds or 5 percent of market value – *because it bears the first risk of loss*.

An interest in a pool of assets would represent value in proportion to its percentage interest if such interest were entitled to distributions and were subject to losses on a *pro rata* basis. But when the interest is subordinated, its value is greatly reduced. How much the residual interest in our simple example would be worth would depend on several factors, particularly on the expected rate of losses on the pool assets, which may be estimated on the basis of the

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[39] In many cases, the total credit risk associated with a particular asset is less than 100 percent, whether due to the creditworthiness of the borrower, collateralization, a guaranty or other enhancement, or other factors.
[40] These discussions of hypothetical securitization structures are necessarily greatly simplified.
[41] Depending upon asset type and performance, such a residual interest may in fact represent more than 100 percent of the probable credit risk.

historical performance of similar assets. If this particular residual interest would be worth, if sold, $2 million, then in order for the sponsor to retain a residual interest having a "market value" of 5 percent the sponsor would be forced to restructure the securitization transaction in an uneconomical manner – issuing and selling only $92 million of notes and retaining a residual in an amount of $8 million, an amount that would greatly exceed the risk retention requirement of Section 15G of the Exchange Act. Few securitizers would proceed under those circumstances.

They should not face that choice. Retention of the $5 million first loss position should satisfy the credit risk retention requirements.

Assume now a transaction, similar to an FRBNY example discussed above, in which a sponsor seeks to securitize a pool of $100 million of residential mortgage loans bearing market interest rates. Because a significant number of loans are delinquent or in default, the loan pool would be valued at a discount to its principal amount. The hypothetical sponsor might structure a securitization in which senior notes having a total principal amount of $85 million and subordinate notes having a total principal amount of $5 million are issued and sold to investors, and an eligible horizontal residual interest having a principal amount of $10 million is issued and retained by the sponsor. In this example, the residual interest represents 10 percent of the maximum theoretical credit risk. However, it represents less than 10 percent of the value of the pool assets, because the return on the residual interest is speculative – it represents the right to receive collections in excess of those that are expected, if the loans outperform expectations.

In this example, the residual interest could have a market value of less than 5 percent of the market value of the pool assets or of the ABS interests, because it bears the first risk of loss. But "market value" should not be what risk retention is about. Section 941(b) of the Dodd-Frank Act mandates that securitizers retain credit risk – not market value risk. Under what we believe to be the Agencies' "market value" interpretation, this sponsor could be required to retain a residual interest in an amount of $10 million or more – a gross distortion of the statutory mandate.

5. The EU Capital Requirements Directive Focuses on True Credit Risk

We believe it is helpful to compare the approach taken by the European Union to credit risk retention by securitizers to the requirements under the proposed rules.[42] In general, like

[42] We recognize that Section 15G of the Exchange Act and Article 122a of the Capital Requirements Directive differ in significant ways. Most notably, Section 15G regulates securitizers, requiring (subject to limitations and exceptions) that they retain an economic interest in a portion of the credit risk of securitized assets, while Article 122a regulates certain investors, assessing a punitive capital charge if credit institutions purchase ABS whose originator, sponsor, or original lender has not retained the requisite risk exposure. However, the goal of aligning the

Section 15G of the Exchange Act, Article 122A of the Capital Requirements Directive ("Article 122a") calls for retention of 5 percent of credit risk, subject to limitations and exceptions. Retention of credit risk under 122a is purely voluntary. However, "credit institutions" may invest in a securitization position only if the originator, sponsor or original lender has disclosed that it will retain the requisite net economic interest in the transaction.

Similar to the proposed rules, Article 122a provides that credit risk may be retained in any of various forms, including vertical (retention of no less than 5 percent of the nominal amount of the tranches sold to investors), horizontal (retention of a first loss position equal to no less than 5 percent of the nominal amount of the securitized exposures), originator's interest (similar to a master trust seller's interest,[43] equal to no less than 5 percent of the nominal amount of the securitized exposures), and randomly selected exposures (similar to the representative sample under the proposed rules, equal to no less than 5 percent of the nominal amount of the securitized exposures). We appreciate that the proposed rules offer greater flexibility in forms of risk retention than Article 122a, particularly by making available such options as a horizontal cash reserve account and L-shaped retention.

However, Article 122a differs markedly from the proposed rules in its approach to horizontal risk retention. Under Article 122a, a securitizer that elects to satisfy the credit risk retention requirement in order to facilitate sales of its asset-backed securities to credit institutions is required, under the horizontal option, to retain the first loss tranche – and, if necessary, other "contiguous positions that are senior to it, but are still the same as, or junior to, any position transferred or sold to investors"[44] – in an amount equal to no less than 5 percent of the *nominal amount* of the securitized exposures.[45] Under Article 122a there are no provisions that increase the amount of required risk retention by capturing "premium," and no substitution of a market value-based calculation for the nominal amount of the securitized assets. The CEBS Guidelines provide that "calculation of the retention requirement is independent of the acquisition price of the exposures to be securitised; for instance, acquiring assets at a discount to nominal value does not in itself impact calculation of the retention requirement."[46] The risk retention requirements of Article 122a are, in this respect, straightforward and easy to calculate.

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interests of securitizers and investors is a common element, and there are many similarities between the two regulatory regimes.

[43] Unlike the proposed rules, under Article 122a this method of risk retention is not limited to master trusts that are used to securitize revolving assets.

[44] CEBS Guidelines, clause 54. We discuss retention of "stacked" subordinate tranches of ABS interests below.

[45] Article 122a sometimes refers to "nominal amount" and sometimes to "nominal value." The CEBS has confirmed that this use of different terminology was not intended and need not be considered in determining the risk exposure to be retained.

[46] CEBS Guidelines, clause 43 n. 8.

We urge the Agencies to consider the approach taken by the European Union on the important issue of measurement of horizontal risk retention when reconsidering the proposed rules.

6. The Proposed Definition of "Credit Risk" Should Not Include Market Risk or Mark-to-Market Elements

The proposed rules would define "credit risk" as meaning:

> (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.[47]

Clause (3) is inappropriate, and we urge that it be removed. This sort of market risk is not "credit risk" subject to initial retention as these terms are commonly understood, and we do not believe that such an expansive view of credit risk is what Congress intended. As discussed above, the concepts of credit risk and the retention by a seller of a portion of that risk are familiar concepts in the capital markets. If a lender lends money to a borrower, the lender's credit risk is the risk that the borrower does not pay the money back, with interest, when due. This risk is not directly related to whether changes in market interest rates, or the public perception of the borrower or its business or prospects, or other factors may increase or decrease the market value of the loan. Similarly, if an investor purchases a typical fixed income security, the investor's credit risk is that the investor will receive less than the return of its principal plus interest at the stated rate. The value of such an investor's investment may fluctuate over time based on market perceptions of the likelihood that the security will incur losses or that the rate of repayment of principal will be slower or faster than expected, or changes in market interest rates, or changes in liquidity or in the economic or investment climate generally, or other factors, but this fluctuation in market value is not "credit risk" as that term is commonly understood. In some cases mark-to-

[47] Proposing Release, 76 Fed. Reg. 24090 at 24156.

market accounting rules may require that holders of ABS reduce the values at which such ABS are carried on their balance sheets. But that is not a risk that the risk retention rules can appropriately address.

We believe that this unduly expansive definition of "credit risk" is intertwined with what we believe is the Agencies' view that a retained first loss position should equal 5 percent of the market value of the pool assets or the ABS interests. It confuses the issues, and we ask that the definition be revised to omit clause (3).

7. Is the Term "Par Value" Needed At All?

For the reasons discussed above, careful and precise clarification of the meaning of "par value" is necessary. As we write this letter we do not know precisely what the Agencies intend by the use of this term. If the Agencies intend a market value approach to a synthetic par value, it is not clear to us how such a construct would operate in the real world of the securitization markets. Unless this is clarified, it would not be possible for a securitizer to determine from the text of the rules what is required in order to satisfy its risk retention obligations.

An alternative, and far preferable, approach would for the term "par value" to be removed from the risk retention rules. It is not necessary. As discussed elsewhere in this letter, risk retention can be measured in more appropriate ways. It appears to us that the artificial construct of "par value" serves no useful purpose other than in the context of the onerous premium capture provisions, which should be withdrawn in any case for the reasons described below. We are concerned that efforts to refine the par value concept in the risk retention rules may only add more complexity and potential confusion.

B. <u>The Scope of "ABS Interest" Should Be More Clearly Defined</u>

The proposed rules would define "ABS interest," in part, as including "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, payments on which are primarily dependent on the cash flows of the collateral owned or held by the issuing entity."[48] Thus the term "ABS interest" appears to be intended to encompass a broader universe of interests than the types of asset-backed securities that commonly are issued in a securitization transaction. As the term "asset-backed security" is now defined in Section 3(a)(79) of the Exchange Act, the term "ABS interest" would be unnecessary unless intended to cover other types of interests.

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[48] *Id.*

It is unclear to us how broad the scope of "ABS interest" is intended to be. A clear understanding of the meaning of "ABS interest" is vitally important to an understanding of how retention of credit risk, in any form, is to be measured. In addition, an unduly broad interpretation of "ABS interest" could render many securitization transactions economically infeasible.

We ask that in revising the risk retention rules the Agencies clarify the scope of this definition. In particular, the following should not be classified as ABS interests:

- Fees payable to a trustee, administrator, master servicer or party performing similar functions.
- Servicing and special servicing fees.
- Fees paid to credit managers, independent advisors or other parties performing services for the issuing entity.
- Rating agency fees, to the extent payable from pool asset cash flows.
- Amounts payable by the issuing entity under a derivative contract.
- Noneconomic REMIC residual interests.[49]

We do not believe that the definition of "ABS interest" was intended to include these types of payment obligations. The use of the term "issue" in the definition suggests that the Agencies generally intended for ABS interests to fall within the Exchange Act definition of "asset-backed security," but phrased the definition of "ABS interest" more broadly in an effort to prevent abuse. The Agencies might have been concerned, for example, that an issuing entity could borrow money pursuant to a loan agreement that would not be deemed to constitute a "security" under the federal securities laws. Unfortunately, the proposed definition of "ABS interest" is so broad as to create genuine concern.

This confusion is increased by the reference in the anti-evasion provisions of § __.12 of the proposed rules (the premium capture provisions) to "any ABS interest" that "[r]epresents a *contractual right* to receive some or all of the interest . . . received by the issuing entity."[50] (emphasis added) It is important to ensure that contractual rights to receive a portion of interest cash flows do not constitute ABS interests if they are fees payable for services rendered to or for the benefit of the issuing entity or holders of the issuing entity's ABS.

Servicing fees and certain other fees may be payable to the sponsor, an affiliate of the sponsor or an unaffiliated third party. The same is true of amounts payable under interest rate or

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[49] Noneconomic REMIC residual interests are discussed below.
[50] Proposing Release, 76 Fed. Reg. 24090 at 24163.

currency swaps or other derivative instruments. If these amounts were to be classified as ABS interests, economic distortion would result. Servicing fees may be payable as a fixed percentage of the principal amount of the loans serviced; as a percentage that varies depending upon the performance of the loans; as incentive compensation based upon the servicer's performance; as fixed dollar amounts payable for certain servicing functions; or in other ways. If a sponsor using vertical retention were required to retain a portion of every servicing fee for each of its securitizations, the cost to the issuing entity of servicing the pool assets would be increased by the amount retained by the sponsor, and the task of accounting for these various small cash flows would be difficult and costly for the sponsor to administer.

We believe it is apparent that a sponsor that satisfies its credit risk retention requirements through vertical retention should not be forced to retain 5 percent of the various fees payable to transaction parties. Nor should the sponsor be compelled to hold an interest in ongoing fee payments to rating agencies; this would expose the rating agencies to the credit risk of the sponsor rather than of the issuing entity, which would be contrary to the purpose of paying rating agency fees over time.[51]

A sponsor should not be required to hold a derivative entered into by the issuing entity to ensure receipt of appropriate amounts of interest cash flows, to hedge against currency exchange risk or for other reasons. The sponsor would most likely feel compelled to hedge these various small interest rate or currency risk positions if it were permitted to do so under the risk retention rules, imposing additional and unnecessary cost. If the sponsor were not permitted to hedge these positions it could be exposed to unreasonable risks.

A sponsor that satisfies its credit risk retention requirements through horizontal retention should not be forced to retain a larger residual interest measured on a basis that includes cash flows paid to transaction parties for services rendered or amounts due under a derivative instrument. Such an approach would increase horizontal retention beyond 5 percent of credit risk in a manner that we believe was not intended by Congress or the Agencies.

We ask that the definition of "ABS interest" be modified to correct this ambiguity.

[51] Under the Federal Deposit Insurance Corporation's securitization "safe harbor" rule, the transaction documents for a securitization of residential mortgage loans must provide that at least 40 percent of the fees and other compensation payable to rating agencies would be payable over the five year period after issuance of the RMBS, based on the performance of surveillance services and of the pool assets. 12 C.F.R. 360.6(b)(4)(i).

III. The Premium Capture Provisions Would Be Destructive and Should be Withdrawn

A. The Basics of Premium Capture: What the Proposing Release Says, and What We Believe Is Intended

§ __.12 of the proposed rules provides that in addition to the amount of credit risk that a sponsor is already required to retain under the other provisions of the proposed rules, a sponsor must establish and fund a premium capture cash reserve account in an amount equal to any amount by which (1) the gross proceeds, net of closing costs paid by the sponsor(s) or issuing entity to unaffiliated parties, received from the sale of ABS interests in the issuing entity to persons other than the retaining sponsor exceed (2) 95 percent of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction (if the retaining sponsor has used the vertical, horizontal, L-shaped or master trust seller's interest method of risk retention) or 100 percent of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction (if the retaining sponsor has used the representative sample, ABCP originator-seller or CMBS B-piece method of risk retention).

For purposes of this calculation, the amount of gross proceeds received is increased by the par value or fair value of any ABS interest retained by the sponsor (other than as required under the risk retention rules) if such retained ABS interest is one that (1) the sponsor does not intend to hold to maturity or (2) represents a contractual right to some or all of the interest and no more than a minimal amount of principal payments received by the issuing entity, and is senior to the most subordinated class of ABS interests.

This premium capture cash reserve account would be fully subordinated, exposed to losses on the pool assets before even the residual interest.

This requirement is so onerous that, as stated in the Proposing Release, "few, if any, securitizations would be structured to monetize excess spread at closing and, thus, require the establishment of a premium capture cash reserve account."[52] We agree. Left unstated in the Proposing Release, however, is what a securitization sponsor that holds premium assets is to do, other than to "structure their securitization transactions in a manner that does not monetize excess spread at closing"[53] – or find an alternative to securitization.

Based upon communications with certain of the Agencies and our review of the Proposing Release, we believe that the Agencies intend that in a securitization of a premium

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[52] Proposing Release, 76 Fed. Reg. 24090 at 24113.
[53] *Id.*

pool, the sponsor would artificially increase the par value of the residual interest by the amount of the premium – thus avoiding the funding of a cash reserve account equal to the amount of the premium, but forcing the sponsor to retain (or try to find a buyer for) a residual interest having a par value representing the premium. It is also possible that in some cases the sponsor could increase the value of other ABS interests in addition to the residual, although it is not clear how this would work in practice.

A sponsor relying on the horizontal method to satisfy its credit risk retention requirements would suffer serious adverse economic consequences – either funding a premium capture reserve account in cash or retaining a very large residual interest. A sponsor relying on the vertical method of risk retention could market 95 percent of the residual to investors in what would appear to resemble the net interest margin, or "NIM," securitizations that were common prior to the financial crisis,[54] but we fail to see why the credit risk retention rules should force a sponsor to sell a subordinated interest-only security – which, in economic substance, is what the synthetic par value amount would represent – rather than a senior interest-only security. Once again, the sponsor would be economically disadvantaged for purposes that appear to be outside the scope of Section 15G of the Exchange Act.

We believe that the premium capture scheme is a response to a view of the Agencies, not clearly articulated in the Proposing Release, that an eligible horizontal residual interest that is equal to at least 5 percent of the par value of all ABS interests in the issuing entity should – perhaps must – have a *market value* equal to at least 5 percent of the value of the pool assets and/or 5 percent of the theoretical gross proceeds that would be generated by sale of all of the ABS interests. The economic result of this approach would be so severe that, if it were implemented through the risk retention rules, many sponsors would avoid securitization. The premium capture provisions appear to be based on a view that all excess spread belongs in the residual interest, and that to allocate any excess interest cash flows in another way inappropriately devalues the residual interest. We believe that this is a misconception.

Further, there may be motives behind the premium capture provisions other than merely ensuring that an eligible horizontal residual interest retains sufficient "value." As proposed, the premium capture provisions would apply even if the sponsor relied upon the vertical or representative sample methods of retention to satisfy its credit risk retention obligations. "Premium" therefore would be forced into the residual even when the method selected by the sponsor to align its interests with those of investors has little or no relationship to the amount of the residual interest. In addition to our other serious concerns regarding the concepts of par value and premium capture, we question why inflating the value of the residual interest,

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[54] *See supra* footnote 24.

particularly when a sponsor retains risk through other means than retention of an eligible horizontal residual interest, should be viewed as an appropriate objective of the proposed rules.

B. The Premium Capture Provisions Should Be Withdrawn

We believe that the premium capture provisions are based on a false premise – that the issuance of interest-only or other premium securities negates a sponsor's retained risk exposure. We agree that an eligible horizontal residual interest that is retained to satisfy the sponsor's obligations under the risk retention rules should not be unreasonably stripped of its proportionate share of cash flows from the pool assets, but that concern can be adequately addressed through more limited measures.

Further, the Agencies should have no interest at all in, and the credit risk retention rules should not address, the relative size or value of the residual interest in a structure in which a sponsor satisfies its risk retention obligations through a method other than horizontal retention.

1. The Agencies' Apparent Intent to Force Excess Spread into the Residual Interest Is Inappropriate and Unreasonable

The FRBNY presentation referred to above states that the premium capture provisions "are expected to make monetization of excess spread very unappealing." Instead, the presentation states, a sponsor would *"leave excess spread at the bottom of the waterfall."* (emphasis added) If we understand correctly that the premium capture provisions are intended to force changes in securitization structures to ensure that the first loss position has a value equal to at least 5 percent of total market value, we urge that this approach be carefully reconsidered.

There is nothing about the characteristics of a residual interest in an issuing entity and interest cash flows in excess of the amount needed to pay interest accrued on the ABS that necessarily connects the two. In many transactions, most of the value of a residual interest is in its entitlement to excess interest. But that is not always the case. Excess spread does not "belong" in the residual interest unless it is put there by the structure mechanics of a particular securitization transaction for a specific purpose.

In some securitization transactions, the residual interest represents a portion of the principal amount of the pool assets as well as an entitlement to certain interest cash flows. This principal amount represents the amount by which the more senior classes of ABS are overcollateralized. Overcollateralization – the amount by which the total principal amount of the pool assets exceeds the total principal amount of the ABS, exclusive of the residual – is a very common form of credit enhancement.

In other securitization transactions, the residual may represent a relatively small portion of the principal amount of the pool assets, or none at all, as of the closing date. Instead, the transaction would be structured such that excess interest would be applied to pay principal on the more senior classes of ABS, reducing their total principal amount to less than the total principal amount of the pool assets and creating overcollateralization. In such a structure, the residual interest would generally receive limited or no cash flow until the amount of overcollateralization had reached a specified target, at which time the residual interest would be entitled to both excess interest and certain principal payments.

These are just two examples of many structural variants. Credit enhancement structures for securitization transactions are driven by the characteristics of the pool assets, economic considerations and investor preferences. In a securitization of pool assets bearing interest at market rates, it is likely that the residual interest would have a principal amount at closing equal to any anticipated overcollateralization. In a securitization of pool assets that are expected to generate a limited amount of excess interest, the residual interest may both have a principal amount at closing and be entitled to excess interest, if any, after additional overcollateralization is created. In a securitization of pool assets having relatively high coupons, excess interest may be applied both to make payments on one or more classes of interest-only securities and to create overcollateralization.

In any of these and many other structures, the value of the residual interest is determined by the expectation that it will receive payments over time, whether in the form of interest or principal collections on the pool assets.

The Proposing Release puts forward a scheme that appears to require that an eligible horizontal residual interest *both* have the most subordinate entitlement to principal and interest *and*, as a result of the operation of the premium capture provisions, potentially be entitled to all excess interest. We can see no justification in Section 15G, and no reasonable economic justification, for this result. We submit that the premium capture provisions are unnecessary, and that any concern about inappropriate diversion of cash flow from the residual interest can be addressed by requiring that an eligible horizontal residual interest represent an entitlement to 5 percent of the aggregate of the cash flows expected to be generated by the pool assets, calculated on the basis of the assumption that there will be no defaults or losses on the pool assets. This approach is discussed further below.

2. Potential Consequences of the Premium Capture Provisions

Unless withdrawn, the premium capture provisions would likely discourage many securitization transactions, change some lenders' origination practices, and increase the cost of some consumer loans.

The premium capture provisions would have their harshest impact on the RMBS and CMBS markets. As noted above, the CMBS market has only recently begun to recover, while the RMBS market, outside of the GSEs, has yet to show much life. The premium capture provisions could severely damage the CMBS market and forestall any recovery in private label RMBS.

The premium capture rules do not appear to consider the costs of origination or otherwise account for a securitizer's cost basis in the pool assets. All that matters under the premium capture provisions as proposed is whether gross proceeds, or deemed gross proceeds, exceed the requisite percentage of par value. The fact that a securitizer may have paid a premium for the pool assets does not appear to excuse the securitizer from being obligated to subordinate the premium, either in a cash reserve account or in the residual interest. In such circumstances there may be very little market for premium loans.

Lenders could react to the premium capture provisions by changing origination practices to avoid above-market rates and instead charge borrowers higher points and fees. Mortgage lenders could be reluctant to grant rate locks to prospective borrowers, due to the risk that market rates move lower and the lender is left with a premium loan that is expensive to securitize.

It is not clear to us whether the premium capture provisions are intended, in whole or in part, to indirectly limit certain lending practices. If such is the case, we suggest that these matters are more appropriately handled directly in regulation of consumer lending.

3. Accounting Implications of the Premium Capture Provisions

The Agencies should also consider the potential effect of the premium capture provisions on the financial statements of securitization sponsors prepared in accordance with generally accepted accounting principles ("GAAP").

We believe that the requirement for a fully subordinated premium capture cash reserve account in addition to the amount of credit risk required to be retained under the proposed rules could prevent sponsors from achieving sale treatment for assets transferred to securitization

vehicles in transactions that otherwise would qualify for de-recognition (sales accounting) under GAAP.

A securitizer's determination of the financial accounting and reporting to accord a securitization transaction can be a complex exercise, requiring an analysis of the application of both consolidation and sales accounting standards, in that order. A securitizer must determine whether it is required to consolidate the special purpose (securitization) entity to which the assets were transferred, by applying the relevant guidance in the FASB's Accounting Standards Codification ("ASC") Topic 810, *Consolidation*. If the securitizer must consolidate the securitization entity, the transferred assets will continue to be reported in the securitizer's financial statements; further analysis (that is, consideration of the sales accounting standards) is moot.

Under ASC Topic 810, the securitizer is required to analyze whether its involvement with the securitization entity provides it with a "controlling financial interest" in the vehicle. As explained in the Federal Reserve Report:

> A securitizer would be required to consolidate the entity that issues the ABS if it has a controlling financial interest in that entity. It would have a controlling financial interest if its involvement with the entity has both of the following characteristics:
>
> 1. The power to direct the activities of the special purpose entity that most significantly affect the entity's economic performance.
>
> 2. The obligation to absorb losses of the entity that could potentially be significant to the entity or the right to receive benefits from the entity that could potentially be significant to the entity.
>
> In short, a securitizer would be the primary beneficiary of a special purpose entity and be required to consolidate the entity if it has *power* over the most significant activities of the entity and it is exposed to *benefits* (including losses) of the entity.[55]

In most cases, a 5 percent horizontal risk retention is expected to expose the holder to benefits (and/or losses) that "could potentially be significant" (viewed from the perspective of the

[55] Federal Reserve Report at 68.

securitization entity). A 5 percent vertical retention, on the other hand, is not expected to meet the "potentially significant" threshold, at least as a general rule. Thus, we share the view expressed in the Federal Reserve Report that horizontal risk retention is more likely to result in accounting consolidation (on the part of the securitizer) than vertical retention.[56]

In those cases in which a sponsor (1) retains a 5 percent vertical slice of the ABS interests and (2) is obligated to fund a subordinated cash reserve account in the amount of any premium capture, the effect of the premium reserve account is akin to imposing an incremental, *de facto* horizontal risk retention on the securitizer. Thus, the securitizer's obligation to fund losses under the premium capture arrangement, alone or in combination with other retention interests, would likely require the securitizer to consolidate the securitization entity.

If the securitizer concludes that it should not consolidate the securitization entity, it is next required to evaluate whether its transfer of the assets from its balance sheet qualifies as a sale for accounting purposes, based on the applying the standards in ASC Topic 860, *Transfers and Servicing*.

The retention requirements may cause a securitizer's transfer of assets to a securitization entity to fail to meet the "legal isolation" criterion required for sales accounting under ASC 860. If the retention requirements trigger the securitizer's consolidation of the securitization entity, the securitizer's consideration of the sales accounting requirements is rendered moot, as noted above.

An extended discussion of the potential consequences stemming from a securitizer's consolidation of a securitization entity – in contrast to the transaction achieving off-balance sheet/sales accounting treatment with respect to the transferred assets – is beyond the scope of this letter. However, suffice it to say that ongoing "on-balance sheet" reporting of securitized assets may adversely affect a securitizer's earnings (at least in the short-run) and, perhaps more importantly for a regulated financial institution, will likely require the entity to maintain more regulatory capital to support the on-balance sheet assets.

C. A Reasonable Approach to Preserving the Economic Integrity of an Eligible Horizontal Residual Interest

Because we do not believe that the Proposing Release clearly expresses the Agencies' intent, it is difficult to be appropriately responsive. When representatives of certain of the Agencies have referred to preserving the value of an eligible horizontal residual interest, it is possible that they meant only that the risk retention rules should be drafted in a manner that

[56] *See* Federal Reserve Report at 72.

would prevent sponsors from creating transaction structures that would artificially reduce the value of the residual interest. We believe that such a standard should be feasible. We agree that sponsors should not be able to manipulate the risk retention rules in order to retain a first loss exposure whose value has been artificially reduced by stripping away cash flows *to which a similar proportion of pool assets would otherwise have been entitled.*

A horizontal exposure equal to 5 percent of the face amount of the ABS interests may represent approximately 5 percent of the value of the pool assets *if* the calculation is made on the basis of an assumption that no defaults or losses occur for the life of the transaction, depending upon the expected timing of interest payments on the residual interest. In other words, if a horizontal residual interest is valued on the basis of assumptions that disregard its subordinated status, it should have a value that approximates 5 percent of the pool assets. However, the value of the residual interest likely would be discounted based on the expected timing of receipt of cash flows.

Reasonable restrictions designed to avoid transaction structures that artificially reduce the value of a residual interest may be appropriate, if properly tailored. For example:

- § __.5 could be revised to require that an eligible horizontal residual interest have the most subordinated claim to cash flows from the issuing entity and that its projected cash flows have a net present value, based on the assumption that there will be no defaults or losses on the pool assets and appropriate assumptions regarding estimated cash flows, discount rate, prepayment rate and interest rates for pool assets having variable interest rates, equal, at a minimum, to approximately 5 percent of the net present value of the total projected cash flows from the pool assets, calculated on the basis of the same assumptions.

- § __.5 could require that an eligible horizontal residual interest that is in the form of an ABS interest that has a principal amount equal to at least 5 percent of the principal amount of the all ABS interests in the issuing entity also be entitled to a proportionate amount of interest cash flows on the pool assets.

Valuing projected cash flows for this purpose based on the assumption that no defaults or losses on pool assets will occur[57] is appropriate, because the risk that losses will occur is precisely the risk that sponsors will be required to retain. Reducing projected cash flows on the basis of an assumed rate of losses before calculating the required risk retention would double

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[57] Cash flow models used to prepare hypothetical ABS principal payment scenarios that are included in offering documents are commonly based on this assumption, among others.

count credit risk. For the same reason, it is appropriate to determine the amount of an eligible horizontal residual interest on the basis of its principal amount, rather than a "par value" based on a market value calculation that reflects consideration of credit risk.

We believe that these or similar approaches could adequately ensure that interest payments to which a 5 percent portion of the pool assets would be otherwise entitled would not be stripped from the eligible horizontal residual interest.

IV. Greater Flexibility in Implementation of the Risk Retention Requirements Is Needed

We appreciate the effort that the Agencies have made to provide multiple methods for satisfying the risk retention requirements. However, we are concerned that, as proposed, the requirements associated with these methods are unnecessarily rigid.

We see no conflict between our request for greater flexibility and our concern that the risk retention rules should not be so complex as to deter securitization. We believe that flexibility in implementation can be achieved without adding undue complexity. We understand and appreciate the Agencies' concern that this complex set of rules not be made unduly burdensome to administer, or so convoluted that it would be difficult for a regulator to determine whether a sponsor is in compliance, and have limited our list of recommendations for additional flexibility in implementation with this concern in mind.

A. Greater Flexibility in Application Would Be Consistent with the Dodd-Frank Act

As we discuss in greater detail below, we believe that the goals of the Agencies in promulgating the credit risk retention rules can be met while permitting greater flexibility in implementation. Each of our recommendations would be fully consistent with the statutory mandate of the Dodd-Frank Act. All that would change under our proposals would be the methodologies for satisfying the credit risk retention requirements, not the requirements themselves. Our recommendations include:

- Broader measures of horizontal risk retention;
- Flexibility in L-shaped retention;
- Greater ability to allocate risk to originators;
- Extension of the B-piece buyer risk allocation option to RMBS transactions; and

- Limited risk retention for partial pools of Qualified Assets.

B. Alternative Forms of Risk Retention Would Be Consistent with the Dodd-Frank Act

Under the proposed rules, only fully funded forms of risk retention would satisfy a sponsor's credit risk retention obligations. As proposed, a sponsor could comply with the rules only by retaining ABS interests, causing a third party to retain ABS interests, funding a cash reserve account, or, if the premium capture provisions apply, both retaining ABS interests and funding a cash reserve. We believe this is unnecessarily restrictive. Alternative methods of risk retention, common in some types of ABS, are as effective as fully funded retention at aligning the interests of a securitization sponsor with those of investors.

ABCP conduits have a long history of providing liquidity and credit enhancement in unfunded form. Support may be provided in the form of an irrevocable bank letter of credit, a surety bond or a guarantee, or in other forms. This unfunded credit enhancement is no less real than funded risk retention, and exposes the enhancement provider to genuine credit risk.

We concede that some sponsors may be more creditworthy than others, and that unfunded risk retention carries the risk that an enhancement provider may be unable, when called upon, to fulfill its payment obligations. But considerations of creditworthiness, while significant to investors, should be irrelevant to the risk retention rules. The purpose of the risk retention mandate is to help to align the interests of securitization sponsors with those of investors – not to provide investors with additional protection for their investments. Investors should of course receive adequate disclosure regarding the form of risk retention and the financial condition of an enhancement provider. But from the perspective of alignment of interests, a sponsor that writes a guarantee or a letter of credit to an issuing entity is as much exposed to risk of loss as a sponsor that holds an eligible horizontal residual interest.

The CEBS has recognized the value of alternative forms of risk retention by "synthetic, contingent or derivative means," expressly including the provision of a letter of credit.[58] We ask that the Agencies carefully consider the merits of permitting sponsors to satisfy their risk retention obligations by retaining unfunded risk exposure through letters of credit, guarantees and other forms.

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[58] CEBS Guidelines, clause 45.

V. Specific Issues under the Proposed Forms of Risk Retention

We appreciate the effort made by the Agencies to provide multiple options for a sponsor to satisfy its credit risk retention requirements. Flexibility in this regard will be very important to many sponsors, and could in some cases mean the difference between a transaction that is feasible and one that would be uneconomic.

With respect to each of the retention options, however, there is a need for some clarification or revision of the proposed rules. In some cases these are minor; in others, they are crucial to making the particular retention option viable. We appreciate the Agencies' consideration of these concerns and recommendations.

A. Vertical Retention

Under the risk retention rules as proposed, a sponsor could satisfy its credit risk retention requirements by retaining not less than 5 percent of each class of ABS interests in the issuing entity issued as a part of the securitization transaction. The proposed definition of "ABS interest" includes any type of interest or obligation issued by an issuing entity, including a residual interest, payments on which are primarily dependent on the cash flows of the collateral owned or held by the issuing entity. The definition also excludes certain interests, but only if they are "issued primarily to evidence ownership of the issuing entity" and any payments on such interests "are not primarily dependent on the cash flows of the collateral held by the issuing entity."[59] It is not clear that this definition would exclude noneconomic REMIC residual interests, and we ask that this exclusion be made explicit.

As discussed above, REMIC residuals have unique tax characteristics, and many securitization sponsors do not retain them. We see no policy reason that would support requiring a sponsor to retain 5 percent, or any portion, of a REMIC residual interest that is not entitled to any material cash flow. In order to avoid this unintended consequence, we ask that the Agencies either specifically exclude noneconomic REMIC residual interests from the definition of "ABS interests" or modify proposed § __.4(a) to require retention of not less than 5 percent of each class of ABS interests other than noneconomic REMIC residual interests.

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[59] Proposing Release, 76 Fed. Reg. 24090 at 24156.

B. Horizontal Retention

1. Amount of Required Horizontal Risk Retention Should Be a True Credit Risk Calculation

As discussed above, a regulatory interpretation that would require sponsors to retain an eligible horizontal residual interest equal to 5 percent of the "market value" of all ABS interests could be highly adverse to many securitizers. Such an interpretation would be contrary to the common understanding of credit risk, and could result in serious economic distortion.

If an investor pays cash for a security, the investor's credit risk is the risk that the investor is not repaid. This risk is unrelated to whether changes in market interest rates or other factors may increase or decrease the price at which the security would trade in the market at any given time. In the case of asset-backed securities, the credit risk associated with securitized loans is that the amount loaned is not repaid by the borrower; with securitized leases, that lease payments are not made by the lessee; with repackaged securities, that such securities are not paid in full. Section 15G of the Exchange Act requires that the Agencies prescribe regulations to require any securitizer to retain an economic interest in a portion of the credit risk *"for any asset"* that is securitized.[60] (emphasis added) As discussed above, we believe that the Agencies have developed a view, not expressly stated in the Proposing Release, that an eligible horizontal residual interest that is equal to at least 5 percent of the par value of all ABS interests in the issuing entity should have a market value equal to at least 5 percent of the value of the pool assets and/or 5 percent of the theoretical gross proceeds that would be generated by sale of all of the ABS interests. This is not, we believe, the correct way to view the credit risk associated with the pool assets.

A determination of market value itself involves an evaluation of, and giving effect to, credit risk, as well as other factors. If a $100 million pool of loans is valued in the market at $95 million, the discount valuation may be due to below-market interest rates on the loans, or to the perceived risk of loss associated with the loans, or to other factors. If a pool's value is discounted due to low yield, that is irrelevant to credit risk and should not affect the calculation of the amount of the first loss exposure. If a pool's value is discounted due to credit risk, the discount valuation should again not affect the calculation of the amount of the first loss exposure, because to do otherwise would be to multiply the risk retention requirement. Nothing in Section 15G states or implies that the amount of risk retention should be increased until it substantially exceeds the market's assessment of the credit risk associated with a pool of assets.

[60] § 15G(b)(1) of the Exchange Act.

We believe that the appropriate measure of the amount of risk retained in the form of an eligible horizontal residual interest is whether the projected cash flows for the eligible horizontal residual interest have a net present value, based on the assumption that there will be no defaults or losses on the pool assets and appropriate assumptions regarding estimated cash flows, discount rate, prepayment rate and interest rates for pool assets having variable interest rates, equal, at a minimum, to approximately 5 percent of the net present value of the total projected cash flows from the pool assets, calculated on the basis of the same assumptions. We urge the Agencies to consider this issue carefully and revise the proposed rules appropriately.

2. Eligible Horizontal Residual Interest Should Be Defined in a Manner That Avoids Unnecessary Interference with Transaction Structures

As proposed, the risk retention rules provide that retention of risk through any of the horizontal, L-shaped, eligible ABCP conduit originator-seller or CMBS B-piece buyer methods would require retention of an eligible horizontal residual interest in an amount equal to at least 5 percent of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction. The proposed rules would define "eligible horizontal residual interest" as an ABS interest in the issuing entity that:

> (1) Is allocated all losses on the securitized assets (other than losses that are first absorbed through the release of funds from a premium capture cash reserve account, if such an account is required to be established under § __.12 of this part) until the par value of such ABS interest is reduced to zero;
>
> (2) Has the most subordinated claim to payments of both principal and interest by the issuing entity; and
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> (3) Until all other ABS interests in the issuing entity are paid in full, is not entitled to receive any payments of principal made on a securitized asset, *provided, however,* an eligible horizontal residual interest may receive its current proportionate share of scheduled payments of principal received on the securitized assets in accordance with the transaction documents.[61]

This proposed definition is unnecessarily restrictive, and would be difficult to implement without significant and, we believe, unnecessary, changes to existing transaction structures. The goals of Section 15G of the Exchange Act and the proposed risk retention rules can be accomplished in other ways.

[61] Proposing Release, 76 Fed. Reg. 24090 at 24157.

Excess Spread. Securitization structures and the methods used to provide internal credit enhancement vary widely. In many securitization transactions in which the pool assets bear interest at relatively high rates the most subordinate, or residual, class of ABS may have a relatively small principal or no principal amount on the closing. Such a residual interest would evidence an entitlement to certain "excess" interest payments and principal payments after sufficient credit enhancement is available to support the more senior classes of ABS. Typically, all or a portion of interest collections in excess of amounts needed to pay interest due on the ABS would be applied to pay principal on the more senior classes of ABS, thus reducing the total principal amount of the ABS to less than the total principal amount of the pool assets, creating overcollateralization.

In such a transaction, after the stated overcollateralization target has been reached and for so long as such requirement is met, excess interest would no longer be applied to pay principal on the more senior ABS but would be paid to the holder of the residual interest. In addition, to the extent that at any time the amount of overcollateralization exceeds the stated overcollateralization target, principal in the amount of such excess would be released to the residual holder.

Losses on the pool assets would reduce the total principal amount of the pool assets, requiring that more excess interest be used to pay principal on the more senior classes of ABS in order to restore the required amount of overcollateralization. Losses on the pool assets therefore decrease the amount of cash received by the residual holder.

Any excess spread residual is in a genuine first loss position and bears significant credit risk. Yet, under the proposed rules, this common securitization structure could not be used by the sponsor to satisfy its risk retention obligations under the horizontal retention method, because an excess spread residual would not qualify as an eligible horizontal residual interest. We ask the Agencies to adopt a different approach. We believe that an excess spread residual should qualify as an eligible horizontal residual interest based on a valuation of expected cash flows. It should be sufficient for this purpose that the projected cash flows for an eligible horizontal residual interest have a net present value, based on the assumption that there will be no defaults or losses on the pool assets and other appropriate assumptions as discussed above, equal, at a minimum, to approximately 5 percent of the net present value of the total projected cash flows from the pool assets, calculated on the basis of the same assumptions.

Payments of Principal. The proposed requirement that an eligible horizontal residual interest not be entitled to receive unscheduled payments of principal would be impractical to administer and is, we believe, unnecessary. In practice, a residual interest would generally be

entitled to payments of principal only to the extent that the more senior classes of ABS are adequately credit enhanced under the terms of the transaction documents and otherwise in accordance with the transaction documents in a manner clearly disclosed to investors. Diverting principal prepayments to the more senior classes of ABS even if they are already adequately credit enhanced would be economically inefficient. If any restriction on payments of principal to a residual interest is necessary, a provision to the effect that such payments could be made only to the extent provided in the transaction documents should be sufficient.

3. Risk Retention Rules Should Permit Greater Flexibility in Horizontal Retention Options

Stacking of Subordinate Interests. As proposed, the definition of "eligible horizontal residual interest" contemplates only "an ABS interest" that, among other things, has "the most subordinated claim to payments of both principal and interest by the issuing entity."[62] We ask that the introductory portion and clause (2) of this definition be revised to include "an ABS interest or a combination of ABS interests" that "in the aggregate have the most subordinate claim to payments of both principal and interest by the issuing entity" – or, if the criteria for qualification as an eligible horizontal residual interest are revised as discussed above, that satisfy the applicable requirements.

In our view, the Agencies should be indifferent as to whether a securitizer satisfies its risk retention requirements through retention of a single "first loss" residual interest in an amount equal to at least 5 percent of the par value of all ABS interests in the issuing entity issued as part of a securitization transaction, or through retention of both a residual interest in an amount equal to a smaller percentage of such par value and a portion of the next most senior tranche of ABS interests in an amount equal to the remaining percentage, such that the aggregate retained interest is at least equal to 5 per cent of the par value of all ABS interests.

We note that this approach is permitted under Article 122a.[63]

For example, in a simple hypothetical term securitization of $100 million of receivables, an issuing entity might issue $93 million of senior notes, $2 million of subordinate notes and a $5 million residual interest. In this transaction, the sponsor could satisfy its risk retention requirement by retaining the entire residual interest. However, the credit quality of the receivables might support issuance of $5 million of subordinated notes and a residual interest of only $3 million. In this case, it should be permissible for the issuer to issue $93 million of senior

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[62] *Id.*
[63] *See* CEBS Guidelines, clause 54.

notes, $3 million of mezzanine notes, $2 million of subordinate notes and a $3 million residual interest, and for the sponsor to satisfy its risk retention obligations by retaining the subordinate notes and the residual interest.[64]

In either case described above, the sponsor will have retained a 5 percent first loss position as to principal and interest. Retention of the two most subordinated tranches of ABS interests in an aggregate amount equal to at least 5 percent of the par value of all ABS interests in the issuing entity issued as part of a securitization transaction satisfies the spirit of the horizontal risk retention model as set forth in the Proposing Release, but not the letter of proposed § __.5(a) and the proposed definition of "eligible horizontal residual interest." We do not believe that this small change would increase the complexity of the rules or make it more difficult to determine whether sponsors have satisfied their risk retention requirements.

Combination of Horizontal Interest and Reserve Account. As proposed, § __.5 of the risk retention rules would permit a sponsor to satisfy its risk retention requirements with respect to a securitization transaction by either (1) retaining an eligible horizontal residual interest equal to at least 5 percent of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction or (2) establishing and funding, in cash, a horizontal cash reserve account in an amount equal to at least 5 percent of the par value of all ABS interests. We ask that the proposed horizontal risk retention provisions be revised to permit a sponsor to satisfy its risk retention requirement through any combination of retention of an eligible horizontal residual interest and establishment and funding of a horizontal cash reserve account equal, in the aggregate, to at least 5 percent of the par value of all ABS interests in the issuing entity, provided that each such ABS interest and account satisfy the applicable requirements of § __.5.

There may be circumstances in which it would be advantageous to a sponsor to fund a portion of its horizontal risk exposure in cash. This could occur due to potential differences in accounting or regulatory capital treatment, or for other reasons. In our view, the Agencies should be indifferent as to whether a sponsor elects to retain risk in the form of a 4 percent eligible horizontal residual interest and a 1 percent horizontal cash reserve account, or in some other proportion. In any such case, the sponsor will have retained the full amount of required subordinated exposure. While we recognize and share the Agencies' legitimate concern that the risk retention rules provide clear guidelines and not be unduly complex to administer, we do not believe that this requested modification of § __.5 would add any additional complexity. Because the nature and value of a cash deposit in a horizontal cash reserve account are straightforward,

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[64] European Union regulators have recognized the usefulness of this approach to horizontal, or "first loss," risk retention. *See* CEBS Guidelines, clause 54.

such a combination of forms of horizontal risk retention would be easily explained to, and easily understood by, investors.

In addition, we ask that it be at the option of the sponsor whether losses be borne first by the eligible horizontal residual interest or the horizontal cash reserve account. Because the Agencies have already determined in proposing § __.5 in its current form that these two forms of risk retention are equivalent, we believe that the Agencies should be indifferent as to whether the eligible horizontal residual interest or the horizontal cash reserve account is in the first loss position.

4. Operation of the Eligible Horizontal Cash Reserve Account Should Be Clarified

As proposed, § __.5(b)(3) would provide that until all ABS interests in the issuing entity have been paid in full or the issuing entity is dissolved, amounts on deposit in a horizontal cash reserve account could be released only under the following circumstances: (1) to 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"; (2) to make *pro rata* payments in respect of scheduled payments of principal received on the securitized assets; and (3) to release investment income on amounts on deposit in the account.[65] The condition described in clause (1) is too narrowly drafted to be practical in most ABS transactions, so we ask that it be modified to permit an issuing entity to make payments from a horizontal cash reserve account in respect of losses realized on the securitized assets. We believe that this clarification would be consistent with the Agencies' intent.

In most securitization transactions, no payment of principal is "due" on any payment date prior to, in the case of ABS issued in the form of notes, the applicable maturity date or redemption date. In the case of ABS issued in the form of pass-through certificates, payments of principal are generally not "due" at any time unless a clean-up call option is exercised or the issuing entity is otherwise terminated prior to payment in full of the related ABS. In most securitization transactions, holders of ABS are not entitled to a cash payment when a loss is realized on a pool asset. In general, unless the ABS or the pool assets are insured, there would be no source of cash to make such a payment. Rather, a principal loss on an asset would generally result in a reduction of the amount of any overcollateralization, or in a reduction of the principal balance of the most subordinate class of ABS. An interest loss on an asset would reduce cash flow available to make payments on the ABS.

[65] Proposing Release, 76 Fed. Reg. 24090 at 24158.

If a sponsor elects to satisfy its risk retention requirement by funding a horizontal cash reserve account, cash should be withdrawn from the account for payment of principal on the most senior class of ABS outstanding in an amount equal to any principal loss realized on a securitized asset. We believe that this is what was intended, and we ask that § __.5(b)(3)(i) be revised to make this clear.

5. *Noneconomic REMIC Residual Interests Should Be Disregarded in Identifying the Eligible Horizontal Residual Interest*

A REMIC residual interest may occupy the most subordinate position in the cash flow waterfall, even though in many cases such a residual interest will be structured so that the likelihood that holders of the REMIC residual will receive any cash flow is remote. We ask that the Agencies modify clause (2) of the definition of "eligible horizontal residual interest" to make clear that an eligible horizontal residual interest must have the most subordinated claim to payments of both principal and interest by the issuing entity (except to the extent that this requirement is modified as discussed above), other than any *de minimis* amounts that may be payable on a noneconomic REMIC residual interest. We view this as a technical clarification, and do not believe that such an exclusion would create an opportunity for avoidance of the risk retention requirements. Each REMIC must file a federal income tax return with the Internal Revenue Service every year; it will be readily apparent if a sponsor has sought to avoid the risk retention requirements by inappropriately characterizing as noneconomic a REMIC residual interest that is in fact receiving material cash flow.

C. L-shaped Retention

As proposed, § __.6(a) of the risk retention rules would permit a sponsor to satisfy its risk retention requirements with respect to a securitization transaction by both (1) retaining not less than 2.5 percent of each class of ABS interests in the issuing entity issued as part of the securitization transaction – *i.e.,* half of the vertical risk retention as provided in § __.4, and (2) either retaining an eligible horizontal residual interest in the issuing entity or establishing and funding a horizontal cash reserve account that satisfies the requirements of § __.5, in either case in an amount equal to at least 2.564 percent of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction other than those ABS interests retained by the sponsor under clause (1) – *i.e.,* half of the horizontal risk retention as provided in § __.5, adjusted to avoid double-counting. We appreciate the availability of the L-shaped retention option under the proposed rules. However, we believe that the terms of this retention are unduly restrictive, and could easily be adjusted to provide greater flexibility while still achieving the Agencies' goals.

We request that the Agencies modify proposed § __.6 to permit any combination of vertical and horizontal risk retention that equals 5 percent plus the double-counting adjustment. We suggest that the Agencies should be indifferent as to whether a sponsor chooses in connection with a particular securitization transaction to, for example, retain 1 percent of each class of ABS interests and 4.040 percent of an eligible horizontal residual interest, or to retain 3 percent of each class of ABS interests and establish and fund a horizontal cash reserve account equal to at least 2.062 percent of the par value of all ABS interests. This could be accomplished easily by revising § __.6(a) as follows:

> At the closing of the securitization transaction, the sponsor:
>
> (1) Retains any portion less than 5 percent of each class of ABS interests in the issuing entity issued as part of the securitization transaction, other than any eligible horizontal residual interest or horizontal cash reserve account (such portion, expressed as a percentage, the "vertical percentage"); and
>
> (2) Retains an eligible horizontal residual interest in the issuing entity, or establishes and funds in cash a horizontal cash reserve account that meets all of the requirements of § __.5(b) of this part, in an amount that in either case is equal to at least the product of (i) the horizontal percentage (as defined below) and (ii) the par value of all ABS interests in the issuing entity issued as part of the securitization transaction *minus* the amount of ABS interests retained pursuant to clause (1) above. The "horizontal percentage" shall be equal to the quotient, expressed as a percentage, of (x) 5.0 percent *minus* the vertical percentage and (y) 100.0 percent *minus* the vertical percentage.

This change would permit a securitization sponsor to tailor the nature of the retained risk exposure to its particular needs and the circumstances of the particular securitization transaction. The sponsor's determination could be influenced by the market for more senior ABS interests, or the size of the horizontal interest as dictated by the subordination requirements of investors or rating agencies, or other factors. In any event, however, under such a revised § __.6(a) the sponsor would retain the full economic 5 percent of credit risk associated with the securitization transaction.

D. Revolving Asset Master Trusts

Retention of credit risk by the sponsor is a common feature of existing securitizations of credit card and charge card receivables, dealer floorplan receivables and other revolving assets, as the Agencies are well aware. We appreciate that the proposed rules would accommodate the master trust structure used in these transactions by allowing a sponsor to satisfy its credit risk

retention obligations by retaining a "seller's interest" that satisfies certain limited criteria. However, although the Agencies indicate in the Proposing Release that "[t]he definitions of a seller's interest and a revolving asset master trust are intended to be consistent with market practices,"[66] the proposed standards for this retention option are inconsistent with market practice in some respects. We ask that the rules be conformed to market practice in order to permit existing master trusts to qualify under proposed § __.7 and to avoid unnecessary changes to structures that already accomplish the goals set by Section 15G of the Exchange Act.

Clause (1)(ii) of the proposed definition of "seller's interest" would require that a seller's interest be an interest in assets that do not "collateralize any other ABS interests issued by the issuing entity."[67] It is not clear to us what is intended by this provision. Generally, all of the receivables held by a master trust would be pledged to secure the notes. We do not believe that this provision adds any useful element to the proposed definition, and because it may create confusion we ask that it be omitted.

Clause (2) of the proposed definition of "seller's interest" would require that the seller's interest "be pari passu with all other ABS interests issued by the issuing entity with respect to the allocation of all payments and losses prior to an early amortization event."[68] Although master trust securitizations generally comply with the spirit of this provision, under some circumstances the seller's interest in most master trust securitizations of revolving assets will be subordinated to the investors' interests with respect to payments, and we ask that the definition be revised to permit this variation.

Under § __.7(a) as proposed, a sponsor seeking to satisfy its risk retention obligations under this option would be required to retain a seller's interest of not less than 5 percent of the "unpaid principal balance of the assets owned or held by the issuing entity."[69] Because revolving master trusts acquire additional asset balances on an ongoing basis and issue new series of ABS only from time to time, this proposed requirement could result in a disproportionately high amount of risk retention. For example, a hypothetical master trust might at a point in time hold $1 billion in receivables but have ABS outstanding in a total principal amount of only $500 million. In this example, proposed § __.7(a) would require retention of a seller's interest having a principal amount of $50 million, while in our view $25 million -- 5 percent of $500 million -- would be the appropriate amount of retained risk exposure. We ask that § __.7 of the final rules be modified to provide that the sponsor be required to retain a seller's interest of not less than 5 percent of the total principal amount (or par value) of the ABS interests in the issuing entity.

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[66] Proposing Release, 76 Fed. Reg. 24090 at 24104.
[67] Proposing Release, 76 Fed. Reg. 24090 at 24157.
[68] *Id.*
[69] Proposing Release, 76 Fed. Reg. 24090 at 24159.

E. Representative Sample

We appreciate the availability under the proposed rules of the representative sample method of retention. However, we are concerned that as proposed this method of retention would be unduly complex and would be unavailable to a significant portion of the market. We ask that the Agencies consider our proposals to make this method of risk retention more practical and more likely to be utilized by securitizers.

1. The Proposed Requirements Are Overly Complex and Unclear

We understand the Agencies' concern that the representative sample of pool assets that is retained by the sponsor should be exposed to substantially the same aggregate credit risks as investors in the ABS. However, as proposed § __.8 of the proposed rules would impose such complex, stringent requirements that few sponsors would be likely to rely on this method of risk retention. A few examples will illustrate our concern:

- For each securitization, the sponsor would need to select a designated pool consisting of at least 1,000 assets from which the retained sample and the securitized pool would be drawn. Such a large pool size would not be feasible in many cases.

- The sponsor would be required to select the retained sample from the designated pool using a random selection process that does not take account of any characteristic of the assets other than their unpaid principal balances. If the selected sample does not satisfy the high standard established under proposed § __.8 for consistency with the material characteristics of the pool to be securitized, the sponsor would be required to repeat the sample selection process again and again until a retained sample that is adequately representative of the material characteristics of the designated pool is identified.

- What pool asset characteristics would be deemed material for this purpose is unclear. In the Proposing Release the Agencies suggest that depending on asset type, material characteristics "might include, for example, the geographical location of the property securing the loan, the debt-to-income ratio(s) of the borrower ("DTI ratio"), and the interest rate payable on the loan. Characteristics such as the DTI ratio and the interest rate payable on the loan would be considered quantitative characteristics, and

characteristics such as the geographic location of the property securing the loan would be considered categorical characteristics."[70]

- Proposed § __.8 provides that the individuals responsible for servicing the assets in a designated pool "must not be able to determine whether an asset is owned or held by the sponsor or owned or held by the issuing entity."[71] While we understand the Agencies' concern that the securitized and retained assets be serviced in the same manner in order to avoid differences in performance due to servicing practices, we do not believe that this standard is practical, particularly in view of the level of disclosure to investors that is likely to be required. If the SEC adopts proposed rule changes that it proposed in April 2010 to require detailed asset-level disclosure in registered offerings and in periodic reports, we doubt that information as to the assets constituting the securitized pool and the retained sample could be shielded from employees of the servicer.

In view of the difficulty of complying with these and other requirements of § __.8 of the proposed rules, we recommend that the Agencies adopt, in addition to the representative sample procedures set forth in proposed § __.8, the alternative approach to retention of a representative sample of the securitized assets that we describe below.

2. An Alternative Approach: Pro Rata Participation Interests

We ask that the Agencies consider whether a *pro rata* asset-level participation structure could be utilized as an alternative to the representative sample methodology that is outlined in the Proposing Release. Loan participation structures have been used for many years by commercial lenders.

Complete Alignment of Interests. Although perhaps not practical for all asset classes, we believe that participations could be a useful risk retention mechanism for many sponsors and, of particular note, retention of participation interests would perfectly align the interests of sponsors and investors. This approach could make a form of representative sample retention available to sponsors of securitizations of larger, less uniform assets, such as residential and commercial mortgage loans. For any asset class for which a participation structure is feasible, this approach would eliminate the problems with representative sample retention described above.

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[70] Proposing Release, 76 Fed. Reg. 24090 at 24105 n. 72.
[71] Proposing Release, 76 Fed. Reg. 24090 at 24160.

Under this approach, the sponsor or an affiliate would enter into a participation agreement pursuant to which each individual asset identified for the securitized pool (a "designated asset") would be divided into two interests – a 95 percent interest that would be securitized and a 5 percent interest that would be retained by the sponsor (or its consolidated affiliate). Each participation interest would share proportionately in all payments of interest and principal, and in any expenses attributable to the participated asset, such as servicing fees and expenses. Any payment shortfalls or losses realized on the underlying asset would be borne proportionately by the holders of the participation interests. Because the servicer would administer each designated asset, not the participation interests, administration of each interest in each designated asset would be identical.

Issues under the Federal Securities Laws. Rule 190 under the Securities Act of 1933, as amended (the "Securities Act") provides that, subject to certain conditions, qualifications and exceptions, in an offering of ABS pursuant to a registration statement where the asset pool includes securities of another issuer, unless the underlying securities are themselves exempt from registration under Section 3 of the Securities Act, the "offering" of the underlying securities must itself be registered as a primary offering of such securities. The Commission has stated its view that "if a loan participation were securitized, that would be viewed as a public distribution of the loan participation and the loan participation would therefore be a security, the offer and sale of which, unless exempt, would be subject to the registration requirements of the Securities Act."[72] Before the Commission articulated this view, it had been common practice in commercial mortgage loan securitizations to participate high balance loans and include a *pro rata* participation interest in the loan in each of two or three securitized pools. However, this structure was largely abandoned in public offerings of CMBS because the process of registration of the offering of each loan participation was viewed as unduly burdensome.

If the Agencies determine to permit sponsors of securitization transactions to satisfy their credit risk retention requirements by retaining a 5 percent *pro rata* participation interest in each designated asset, we ask that the SEC clarify that the related 95 percent participation in each designated asset that is securitized would not, under these circumstances, constitute a separate security requiring separate registration.

F. Eligible ABCP Conduits

We appreciate the Agencies' inclusion of a risk retention option specifically designed for ABCP conduits. This option would permit the sponsor of a qualifying ABCP conduit vehicle to

[72] Asset-Backed Securities, Securities Act Release No. 33-8518, 70 Fed. Reg. 1506, 1529 n. 173 (Jan. 7, 2005).

meet its risk retention requirements if each "originator-seller" that transfers assets to collateralize the ABCP retains certain credit risks.

Several aspects of the proposed ABCP-specific risk retention option mean that it will be of limited usefulness to ABCP conduits currently in existence. According to the Proposing Release, "[t]his option is designed to take account of the special structures through which this type of ABCP typically is issued, as well as the manner in which exposure to the credit risk of the underlying assets typically is retained by participants in the securitization chain for this type of ABCP."[73] Given the conflict between these aspects of the proposed ABCP-specific risk retention option and typical ABCP conduit structures, as further described below, this option will not fulfill its express purpose unless the proposed rules are modified to mitigate those conflicts.

For the sponsor of an eligible ABCP conduit to take advantage of the ABCP risk retention option, each originator-seller to the conduit would be required to retain the same amount and type of credit risk as would be required under the horizontal risk retention option, if the originator-seller was the sponsor of the "intermediate SPV" to which the assets are transferred (and which issues the ABS interests that collateralize the ABCP). In other words, the applicable originator-seller must retain an eligible horizontal residual interest in each intermediate SPV equal to at least 5 percent of the par value of all interests issued by the intermediate SPV.

The sponsor would be required to disclose to investors the identity of each originator-seller that retains such a residual interest, and the form, amount and nature of its residual interest. In our view, disclosure of the name of each originator-seller, at least for a multi-seller ABCP conduit, would be impractical. Such disclosure is not current practice in the ABCP markets, and we believe that it would not be permitted by most originator-sellers, even if they were willing to retain the required risk. Therefore, unless this requirement is eliminated, we believe that the availability of this important financing mechanism could be severely curtailed. In any event, we do not believe that information regarding the identities of the possible multitudes of seller-originators into any particular ABCP conduit is of much real interest to investors in ABCP, who generally focus on the identity and reputation of the sponsor and the creditworthiness of the liquidity provider.

Another requirement of the proposed ABCP risk retention option would be that the ABS issued by an intermediate SPV must be collateralized solely by assets originated by a single originator-seller. We understand that many intermediate SPVs controlled by an affiliated corporate group aggregate assets originated from multiple affiliated originator-sellers within that

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[73] Proposing Release, 76 Fed. Reg. 24090 at 24107.

corporate family. Under the proposed rules, a multi-seller conduit accepting assets from such an SPV would not qualify for the ABCP risk retention option, but it is not clear what purpose is served by this requirement, as it is characterized merely as a "[condition] designed to ensure that this option is available only to the type of . . . ABCP conduits" described generally in the Proposing Release.[74] We believe that the ABS issued by an intermediate SPV should be permitted to be collateralized by assets originated by multiple affiliated originator-sellers, that this is common industry practice, and that there is no harm in allowing that practice to continue.

The proposed ABCP risk retention option also would require that all of the interests issued by an intermediate SPV be transferred to one or more ABCP conduits or retained by the originator-seller. This would effectively prohibit the financing of assets owned by an intermediate SPV by means other than the issuance of ABCP, something that we understand is relatively common. Again, the only reason given by the Proposing Release for this restriction is that it is " designed to ensure that this option is available only to the type of . . . ABCP conduits" described generally.[75] In our view, the intermediate SPV should be permitted to transfer the interests it issues to other types of entities, and therefore to finance the underlying assets through ABCP as well as bank loans and other methods. If the transfer of intermediate SPV interests is limited to the issuance of ABCP, then the finite aggregate capacity of ABCP conduits may limit the ability of seller-originators to obtain otherwise available financing.

The proposed ABCP risk retention option would not permit an originator-seller to sell to an intermediate SPV, and then finance through the issuance of ABCP, any assets that it did not itself originate. Under current market practices, financial assets sold to intermediate SPVs are often acquired in acquisition transactions financed through the issuance of ABCP. Effectively prohibiting this type of financing would shut off a valuable and cost-efficient source of acquisition financing, and in our opinion would adversely affect the market for these assets. In our opinion, the ABCP risk retention option should permit the financing of assets originated by parties other than the risk-retaining originator-seller.

Under the proposed ABCP risk retention option, only the horizontal interests retained by originator-sellers would count toward the aggregate 5 percent risk retention requirement. However, in addition to the liquidity enhancement contemplated by the proposed ABCP risk retention option, ABCP programs also are commonly structured with credit enhancement to protect against losses on the underlying asset pool. While the support may be structural, such as overcollateralization, subordination or excess spread, credit support also may be provided by independent mechanisms. For example, in some cases an ABCP conduit will feature a cash

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[74] *Id.*
[75] *Id.*

reserve account. Sometimes, the liquidity facility will be structured to cover some credit risks in addition to liquidity risks. And in other structures, credit support is provided by a third party, such as under an irrevocable letter of credit, an insurance policy or other guarantee, or a derivative such as a total return swap. These features would not count toward the proposed rules' risk retention requirement. As discussed above, we believe that these forms of credit enhancement satisfy the requirement of Section 15G that the securitizer retain an economic interest in a portion of the credit risk for each asset that it securitizes, and should (depending on the amount of enhancement) satisfy all or a portion of a sponsor's risk retention obligations under the proposed rules. These forms of risk retention are real and substantial, and we believe they accomplish the goal of aligning the sponsor's interests with those of investors.

VI. Allocation of Retained Credit Risk Among Various Transaction Parties

A. Greater Flexibility Is Needed in Allocating Retained Risk between Sponsors and Originators

As proposed, § __.13 would allow a sponsor to allocate risk retention to an originator of securitized assets, but only under very limited circumstances. Among other things, under the Agencies' interpretation an "originator" that agrees to share retention of credit risk would be required to have been the original creditor, and "not a subsequent purchaser or transferee."[76] In addition, the retaining originator must retain at least 20 percent of the aggregate amount of required risk retention, meaning – because retention of risk by an originator must be proportionate to the amount of assets originated by that originator that are included in the securitized pool – an originator whose originations constitute less than 20 percent of a pool would be prohibited from sharing in the risk retention. These conditions would reduce the practicality of reliance on proposed § __.13 to satisfy a sponsor's risk retention obligations.

1. *The Narrow Interpretation of "Originator"*

The Agencies' interpretation of "originator" would have the effect of eliminating many of the parties that might in fact transfer assets to a securitizer and be willing, potentially, to share in the retention of credit risk. In some cases, the party from which a securitization sponsor acquires pool assets, though not itself the original creditor, may be a party that could appropriately be viewed as the originator for purposes of allocation of risk retention. We refer to such a party that transfers assets to a sponsor as a "transferor." Under some lending arrangements a correspondent lender applies the underwriting criteria of a transferor in originating assets pursuant to an agreement whereby the transferor had committed to purchase from the

[76] Proposing Release, 76 Fed. Reg. 24090 at 24099.

correspondent lender assets that satisfy the transferor's criteria. If there was such a pre-existing relationship between a correspondent lender and a transferor that purchased the assets, many securitizers would conclude that, for purposes of satisfying the prospectus disclosure requirements of Regulation AB under the Securities Act, the transferor that had committed to and did purchase assets originated in accordance with its specified criteria, and not the correspondent lender, is the true "originator." Such a circumstance should be distinguished from secondary market purchases of assets, where a transferor may review assets post-origination for conformity with its guidelines, but there was no pre-existing relationship between the parties and no prior commitment to purchase.

We recognize that the Agencies are not starting with a blank slate when determining who may be considered an originator for purposes of risk retention. Section 15G(a)(4) of the Exchange Act defines "originator" to mean a person who, "*through the extension of credit or otherwise,* creates a financial asset that collateralizes an asset-backed security" and "sells an asset directly or indirectly to a securitizer." (emphasis added) Congress could have chosen to use the term "creditor" or "original creditor," but did not do so. We ask the Agencies to consider whether it is reasonable to conclude that, where (1) a correspondent lender applies the underwriting criteria of a transferor in originating assets (2) pursuant to an agreement whereby the transferor had committed to purchase from the correspondent lender assets that satisfy the transferor's criteria, and (3) the transferor transfers the assets directly or indirectly to a securitizer, the transferor is the party that substantively created the assets and may therefore be treated as the "originator" for purposes of the risk retention rules.

2. The 20 Percent Threshold

As proposed, § __.13 would require as conditions to the ability of a sponsor to allocate a portion of its required credit risk retention to an originator that, among other things, that (1) the originator acquire and retain at least 20 percent of the aggregate risk retention amount otherwise required to be retained by the sponsor and (2) the proportion of credit risk retained by the originator for this purpose not exceed the proportion of the securitized pool assets originated by that originator. The proposed 20 percent threshold is too high. This requirement would place added pressure on smaller mortgage originators, reducing their ability to sell their originations to securitizers. It is predictable that a securitizer that has otherwise been successful in reaching agreement with originators to retain a portion of the credit risk in its securitization transactions would be less eager to do business with a smaller originator that may not be able to produce enough loans between planned securitizations to satisfy the 20 percent threshold. Smaller originators could find their portfolios less liquid and/or their sales prices less favorable.

We believe that it would not materially increase the complexity of compliance if a sponsor is permitted to allocate credit risk proportionately to originators without any minimum percentage restriction. The allocation of credit risk would be just as easy to disclose clearly to investors and to regulators, whether there are five or ten or more originators involved in a transaction. As a practical matter some securitizers may choose to limit such allocations for their own administrative convenience, but we do not believe that this should be a regulatory concern.

3. The Sponsor's Responsibility for Compliance with the Risk Retention Requirement

Proposed §__.13(b) provides that the retaining sponsor "shall be responsible for compliance" with the retention requirements and "[s]hall 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 obligation with the" applicable requirements.[77]

It is not clear to us what procedures a sponsor could reasonably perform with respect to monitoring the compliance of originators with the requirements that the originators retain the requisite ABS interests and that the originators do not hedge or finance those interest other than in accordance with the rules other than to request certifications of compliance. We believe that if a sponsor obtains a contractual commitment from the originator to comply with the risk retention rules and requests, at least annually, from the originator a certification of an authorized officer of the originator that the originator is in compliance with the applicable provisions of §__.13, the sponsor should be deemed to have satisfied its compliance burden.[78] We ask that §__.13 be revised to state this specifically. As a practical matter, there is little or nothing that a sponsor could reasonably do to ensure compliance by an originator other than to obtain this commitment and certification.

B. Allocation of Retained Credit Risk Between Sponsors and CMBS B-Piece Buyers or ABCP Originator-Sellers

1. Allocation of Risk Among Multiple Parties

As proposed, § __.10 appears to permit a sponsor to satisfy its credit risk retention obligations through this alternative method only if a single party purchases the entire eligible

[77] Proposing Release, 76 Fed. Reg. 24090 at 24163.
[78] It should be sufficient for this purpose that the sponsor requests the certification, whether or the certification is received. If the certification is not received, then the sponsor should presume that the originator did not comply with its risk retention obligations and would have the disclosure obligation provided in §__.13(b)(2)(B) of the proposed rules.

horizontal residual interest. This is unnecessarily restrictive. The goals of the risk retention rules can be met while permitting sponsors the ability to allocate a portion of the credit risk to a third-party B-piece buyer, similar to allocation of a portion of the credit risk to an originator as permitted by § __.13. In addition, we ask that § __.10 be modified to allow a sponsor to allocate credit risk to multiple B-piece buyers. As in the case of allocation of risk to multiple originators, we believe that this allocation to multiple parties could easily be disclosed clearly to investors and regulators, and would not add undue complexity.

2. Responsibility for Compliance

§§__.9 and __.10 of the proposed rules provide that a sponsor that has allocated a portion of the credit risk that it is required to retain to an ABCP originator-seller or a CMBS B-piece buyer "shall be responsible for compliance" with the retention requirements and '[s]hall maintain and adhere to policies and procedures that are reasonably designed to monitor the compliance" by such third party with the applicable requirements.[79]

As noted above with respect to allocation of credit risk to originators, this vague compliance standard should be clarified. If a sponsor obtains a contractual commitment from the an originator-seller or B-piece buyer to comply with the risk retention rules and requests, at least annually, a certification of an authorized officer of the third party that the third party is in compliance with the applicable provisions of § __.9 or __.10, as applicable, the sponsor should be deemed to have satisfied its compliance burden. We ask that §§ __.9 and __.10 be revised to state this specifically.

C. <u>Allocation of Retained Credit Risk Between or Among Sponsors</u>

Under § __.3(b) of the proposed rules, in a securitization transaction having two or more sponsors "it shall be the responsibility of each sponsor to ensure that at least one of the sponsors" retains the amount of credit risk required under the rules.[80] As explained in the Proposing Release, "[i]n circumstances where two or more entities each meet the definition of sponsor for a single securitization transaction, the proposed rules would require that one of the sponsors retain a portion of the credit risk of the underlying assets in accordance with the requirements" of the rules.[81] It is not clear to us why it should not be possible for multiple sponsors to agree to allocate the required amount of retained credit risk among themselves, so long as the aggregate amount retained satisfies the requirements of the risk retention rules, and we ask that proposed § __.3(b) be revised to accommodate such allocation.

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[79] Proposing Release, 76 Fed. Reg. 24090 at 24161.
[80] Proposing Release, 76 Fed. Reg. 24090 at 24158.
[81] Proposing Release, 76 Fed. Reg. 24090 at 24098.

Securitization transactions with multiple sponsors are not uncommon. For example, some recent CMBS transactions have two sponsors. Forcing one sponsor to retain all of the required risk exposure would unnecessarily complicate the economics of these transactions, and could unfairly disadvantage one sponsor versus another. Presumably some financial accommodation would need to be negotiated between the sponsors to minimize the disproportionate economic impact on the retaining sponsor. However, absent changes to § __.14 of the proposed rules, it is not entirely clear that this could be accomplished without violating the anti-hedging provisions.[82] In a securitization with two or more sponsors, the retaining and non-retaining sponsors might need to negotiate compensation not just for the amount of the purchase price of the retained interests but also for the retaining sponsor's ongoing unhedged risk exposure in an amount disproportionate to the retaining sponsor's economic interest in the securitization.

This seems to us to be a simple change to the proposed rules that could be easily accommodated and could be clearly disclosed to investors and regulators.

In addition, without regard to whether only one, some or all of multiple sponsors may or must retain credit risk with respect to a securitization transaction, it is important that the responsibility of the other sponsors be limited. As discussed above with respect to allocation of retained risk to originators, originator-sellers and B-piece buyers, a sponsor should be able to discharge its responsibility in this regard if it requests, at least annually, from each other sponsor having an obligation to retain credit risk a certification of an authorized officer of each other such sponsor that such sponsor is in compliance with the applicable provisions of the proposed rules.

VII. Limitations on Transfer of Retained ABS Interests and on Hedging of Risk Exposure

We explained above our concern that retention of a minimum amount of credit risk for the life of every securitization transaction could be an unreasonable burden for sponsors to bear, and asked that the Agencies terminate the risk retention requirement after no longer than three years. In addition, we ask that the Agencies consider the following concerns regarding limitations on transfer and hedging of retained credit exposure.

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[82] Proposed §__.14(b) provides that "[a] retaining sponsor . . . may not enter into an agreement . . . with any other person if . . . [p]ayments . . . under the agreement . . . are materially related to the credit risk of one or more particular ABS interests . . . that the retaining sponsor is required to retain with respect to a securitization transaction."

A. Limitations on Transfer of Retained ABS Interests

As proposed, § __.14(a) would prohibit a sponsor from transferring any credit risk the sponsor was required to retain under the risk retention rules, other than to a consolidated affiliate. Originators, ABCP originator-sellers and CMBS B-piece buyers would be bound by this same limitation.

In addition to limiting the retention requirement to a maximum period of time, the risk retention rules should accommodate the possible need for a sponsor or other retaining party to react to future changes in its business, financial condition or circumstances generally. Future events could include sale of a substantial portion of the assets of a sponsor or its affiliate, such as sale of an entire business unit or severe financial stress, whether due to factors affecting the company specifically or to general economic conditions. In addition, future changes in applicable accounting principles or regulatory capital requirements could create a need to transfer risk positions. It would not be reasonable to expect that a sponsor or other retaining party to be able to envision all possible future events or circumstances that may affect its business. We ask that the rules permit the sale or other transfer of retained risk positions, with the prior approval of the applicable regulatory Agency, in circumstances where such is warranted by future events affecting the retaining party. We believe that these sorts of occurrences will be infrequent, and that a reasonable accommodation to permit a sponsor or other retaining party to respond to changing conditions would not create an opportunity for abuse or avoidance of the risk retention requirements.

B. Limitations on Hedging of Retained ABS Interests

We are concerned that the proposed limitations on hedging activity by issuing entities are far too broad, and could unreasonably limit securitization structures.

It is not clear to us that such a strict limitation on hedging by issuing entities was intended, although the text of the proposed rules appears to severely limit the availability of credit enhancement and other support for securitizations. The proposed rules explicitly provide that an issuing entity would not be a consolidated affiliate of a sponsor even if its financial statements are consolidated with those of the sponsor or another affiliate, and would therefore not be subject to the hedging restrictions applicable to sponsors and their consolidated affiliates. The Proposing Release states that this provision "is designed to ensure that an issuing entity may continue to engage in hedging activities itself because such activities would be for the benefit of all investors in the asset-backed securities."[83]

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[83] Proposing Release, 76 Fed. Reg. 24090 at 24116.

However, § __.14(c) of the proposed rules would prohibit the issuing entity in a securitization transaction from purchasing or selling a security or other financial instrument, or entering into an agreement, derivative or position with any other person if (1) payments under any such instrument "are materially related to the credit risk of one or more particular interests, assets or securitized assets that the retaining sponsor . . . is required to retain" under the risk retention rules and (2) such instrument "in any way reduces or limits the financial exposure of the sponsor to the credit risk."[84] This language, read in conjunction with the two examples given by the Agencies of how this limitation would affect securitization structures, raises significant concerns that the hedging prohibition is overly broad.

The first example given is that if a sponsor satisfies its credit risk retention obligations through the vertical retention method, a credit insurance wrap that might otherwise cover losses on one or more classes of ABS could not benefit the interests retained by the sponsor.[85] Although we believe that the limitation on payments under an insurance wrap contemplated by the Agencies could be accommodated by securitizers if needed, we question the necessity for this prohibition. A securitizer that satisfies its risk retention obligations by retaining a vertical slice of each class of ABS interests should be exposed to the same risks as the holders of each class. If one or more classes – typically senior or senior support classes – have the benefit of an insurance policy and their credit risk is therefore limited to the risk of nonpayment by the insurer, the sponsor should be exposed to the same risk.

Limitations on other common forms of credit enhancement could pose greater challenges for securitization structures. For example, if under a pool insurance, bulk private mortgage insurance or residual value insurance policy an insurer is obligated to make certain payments to the issuing entity upon the occurrence of losses on pool assets, would such an arrangement violate the hedging prohibition of § __.14(c)? It should not, because in such a case payments under the insurance policies would not be for the direct benefit of holders of particular classes of securities but rather would be applied in order of priority of payment under the transaction documents, and because such policies typically would cover only a portion of potential losses. Such insurance coverage would be, in the words of the Proposing Release, "for the benefit of all investors" in the ABS; yet, it is not clear that these forms of credit enhancement would be permitted under proposed § __.14(c).

We acknowledge the Agencies' legitimate concern that sponsors not use credit risk hedging techniques available to issuing entities to avoid the risk retention requirements.

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[84] *Id.*
[85] Proposing Release, 76 Fed. Reg. 24090 at 24117.

However, asset-level and pool-level insurance are legitimate credit enhancement tools of long standing, and we ask that they be permitted in all cases. Credit enhancement that covers a portion of losses on one, some or all of the pool assets would benefit all holders of ABS issued by the issuing entity, not only those ABS interests retained by the sponsor, and would not eliminate the retaining sponsor's exposure to credit risk. The reduction in credit risk achieved through the enhancement would accrue to holders of all classes of ABS interests in the securitization, and would not change the relative distribution of risk among interest holders.

If the Agencies determine not to provide a blanket accommodation for asset-level credit enhancement, we ask that the rules clarify what types of asset-level enhancement are permitted. In the second example of how the limitations on hedging by issuing entities would operate in practice, the Agencies note in the Proposing Release that the prohibition on issuing entity credit hedges, as proposed, "would not prohibit an issuing entity (and indirectly its investors) from being the beneficiary of loan-level private mortgage insurance (PMI) *taken out by borrowers* in connection with the underlying assets that are securitized."[86] This clarification, though welcome, is extremely limited. In view of this example, we would presume that, at a minimum, any type of credit enhancement at the asset level that is arranged prior to, and not specifically in contemplation of, the securitization transaction would be permitted. We ask that the Agencies both confirm this interpretation and consider carefully whether the exceptions to the anti-hedging provision must be so narrow.

VIII. Issues for Particular Types of Securitization Transactions

Many of the issues that we discuss in this letter affect a broad range of ABS asset classes. We address below certain matters that disproportionately affect particular types of asset-backed securities.

A. Securitizations of Residential Mortgage Loans

As the Agencies are well aware, there has been little activity in the "private label" securitization market for residential mortgage loans in the past four years. Other than securitizations by Fannie Mae and Freddie Mac, there have been only a handful of securitizations of recently-originated residential mortgage loans, as well as several securitizations of pools of subperforming and nonperforming mortgage loans. The credit risk retention rules, as proposed, would have a particularly harsh impact on this market, further delaying, or forestalling, a recovery of the RMBS market.

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[86] Proposing Release, 76 Fed. Reg. 24090 at 24116 n. 111 (emphasis added).

Several aspects of the proposed rules that would have particular impact on RMBS transactions are discussed elsewhere in this letter. These include the proposed premium capture provisions and the Agencies' possible "market value" interpretation of par value; the narrow definition of "eligible horizontal residual interest"; the inability of RMBS sponsors to utilize the representative sample method of risk retention as proposed; and the need to revise the proposed definition of "qualified residential mortgage" in material respects.

1. Allocation of Risk to RMBS B-Piece Buyers Should Be Permitted

As we discuss in detail below, we are concerned about the reasonableness and practicality of some of the conditions that would be imposed upon a sponsor's ability to allocate risk retention to a third-party purchaser of an eligible horizontal residual interest under the proposed rules. Subject to those concerns, we urge the Agencies to consider expanding the risk retention option proposed in § __.10 to sponsors of securitizations of residential mortgage loans.

We believe that residential mortgage securitization sponsors that are willing to make the necessary adjustments to their transactions could potentially benefit from the ability to allocate horizontal risk retention to a third-party purchaser. We recommend that, subject to our concerns discussed below, the conditions to reliance by a sponsor on this risk retention method be substantially identical to those for sponsors of CMBS transactions – with one important exception. The purchaser's review of the pool assets would need to be performed to a different minimum standard in order for that review to be both practical and beneficial.

As proposed, § __.10(a)(3) would require that a third-party purchaser of an eligible horizontal residual interest conduct a review of the credit risk of "each securitized asset" prior to the sale of the related ABS, and that this examination include, at a minimum, a review of the "underwriting standards, collateral and expected cash flows" of each loan in the securitized pool. These minimum criteria are appropriate for commercial mortgage loans, but a review of the collateral and cash flow of the loans would not be appropriate in the context of an RMBS transaction. We suggest as an alternative that the minimum standard for review in a residential mortgage loan securitization include a review of the "underwriting standards, creditworthiness of the borrower(s) and valuation of the collateral."

In addition, it would not be practical in many cases for a purchaser of an eligible horizontal residual interest to perform a review of every loan in an RMBS pool – although in some transactions the purchaser may choose to do so, depending upon the purchaser's judgment as to loan quality and other factors. However, we recognize the importance of requiring that the purchaser's review address a statistically significant sample of the securitized loans. We propose that the third-party purchaser of an eligible horizontal residual interest in an RMBS transaction

be required to conduct a review of a minimum of the greater of 20 percent of the securitized mortgage loans (by principal balance) and 200 loans.

B. Securitizations of Commercial Mortgage Loans

The opportunity for a sponsor of a CMBS transaction to be able to allocate risk to a third party that purchases an eligible horizontal residual interest is a welcome and important aspect of the proposed rules. However, we are concerned that the proposed criteria set forth in § __.10, particularly those regarding the powers of the operating advisor, would discourage the use of this option.

Under § __.10 as proposed, a third-party B-piece buyer could not have "control rights," including acting as servicer or special servicer, unless an independent operating advisor having certain duties and powers is appointed. Among other things, the operating advisor could replace the B-piece buyer (or its affiliate) as servicer upon a determination "in its sole discretion" that the servicer has not fulfilled its obligations unless a majority of holders of every class of ABS interests votes to retain the servicer.

We are concerned that the power granted to the operating advisor under the proposed rules is too broad, and the risk to the B-piece holder too great, for these procedures to be practical. Except in the most serious instances of default, a servicer should not be removed without first having an opportunity to cure. A servicer should not be removed without an affirmative vote of securityholders. Importantly, if the B-piece holder or its affiliate is removed as servicer, such holder should not be obligated to continue to hold the eligible horizontal residual interest.

There are other important issues under § __.10. Our members expect to have additional comments on issues affecting CMBS transactions at a later date.

C. Collateralized Loan Obligations

Generally, a managed collateralized loan obligation ("CLO") is a pool of syndicated loans selected and managed by an independent third party manager, similar to a closed end fund or a separate managed account. The CLO manager engages an investment bank or other entity to assist in structuring the transaction (including jointly establishing the eligibility and reinvestment criteria for the underlying loans, establishing the CLO issuer and interfacing with the rating agencies) and in marketing the issuer's debt securities. The CLO manager, on behalf of the issuing entity, purchases and trades in a limited number (ordinarily, 100 to 250) of syndicated corporate loans for the benefit of investors, consistent with the established eligibility and

reinvestment criteria. These loans generally are sourced by the manager through third-party market purchases, but may include loans sourced or originated by the investment bank or its affiliates. In each case, the manager performs its own diligence and credit analysis before making a purchase decision. The issuer issues debt securities which generally are rated by one or more rating agencies and unrated equity securities, all of which, together with the transaction structure (including the eligibility and reinvestment criteria for the pool loans), are fully described in offering materials.

These loans in which managed CLOs invest generally are originated by a lending syndicate led by a lead lender, which engages in a credit approval process appropriate and typical for the loan type. Each lender performs its own financial due diligence (which generally includes a review of audited financial statements) on the borrower and give input on the final loan documents, which usually are drafted by the lead lender's counsel. Syndicated corporate loans are generally priced daily by third-party pricing services and interests therein are widely traded by financial institutions. This leads to a much greater degree of transparency than for most financial assets underlying ABS.

1. There Is No "Securitizer" in a CLO

The Proposing Release attempts to identify a "sponsor" for CLOs, including by expressing (in a footnote) the view of the Agencies that the CLO manager generally acts as the sponsor of a CLO.[87] We believe that this is incorrect. Section 15G(b)(1) of the Exchange Act mandates that the risk retention rules require "any securitizer" in a securitization transaction to retain the required risk. A "securitizer," as defined in Section 15G(a)(3), means the issuer of the ABS, or "a person who organizes and initiates an [ABS] transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity," a phrase identical to the definition of "sponsor" under Item 1101(l) of Regulation AB and which is repeated in the definition of "sponsor" in the proposed rules. In the Proposing Release, the Agencies conclude that it is most appropriate to apply the risk retention requirements to the sponsor.

What the Agencies fail to recognize, however, is that *there is no sponsor, or "securitizer,"* as defined, in a typical CLO transaction. A CLO manager, while it may be deemed to organize and initiate the CLO transaction, does not sell or transfer assets to the issuing entity – it simply negotiates the terms of purchase of those assets, which are acquired in the market by the issuing entity from third parties that have no role in organizing or initiating the CLO transaction. Similarly, a CLO arranger does not fit the "sponsor" definition if it is not

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[87] Proposing Release, 76 Fed. Reg. 24090 at 24098 n. 42.

organizing or initiating the CLO transaction or if it is not transferring any assets to the CLO. Therefore, we believe that under the plain language of the Dodd-Frank Act, the proposed rules should not subject the CLO manager to their risk retention requirements. Nor is there another party to these transactions that readily fits the definition of "sponsor."[88]

2. The Proposed Rules Would Impose an Onerous Risk Retention Requirement Where It Is Not Needed

The proposed rules treat managed CLOs the same as any other type of ABS, in requiring full 5 percent risk retention by the sponsor. This decision by the Agencies, if not reversed, would jeopardize the future of an important market.

While CLOs are similar to ABS in some superficial ways, CLOs are very different from other types of securitizations in which the market became highly distressed, such as RMBS transactions and CDOs of ABS. The CLO market has maintained a very low default rate, even in the depths of the recent economic crisis. According to recent testimony given by Bram Smith, the Executive Director of the Loan Syndications & Trading Association, before the House Subcommittee on Capital Markets,[89] "there are more than 630 cash flow CLOs outstanding today," and "there have only been two payment defaults, neither of which caused losses for investors holding notes rated A or better," which represents performance superior to that of the corporate bond market. According to that testimony, while "85% of the CLO notes originally rated Aaa by Moody's were still rated Aa or better following the downgrade sweep," many of the downgrades that have occurred resulted from the rating agencies' making their criteria much more strict rather than any change in the performance of the CLOs themselves, and more than 430 CLO notes were upgraded in the first three months of 2011. CLOs serve as a valuable source of financing for lenders to middle-market and larger companies, as they help to ensure the availability of less expensive financing sources for such companies as well as an active secondary market for loan assets. According to Mr. Smith's testimony, in 2010 alone CLOs provided more than $250 billion in financing to these companies. This capacity is especially important at a time when new capital rules are likely to discourage banks from lending to smaller, non-investment grade companies. Based on historical performance this strong, there simply is no practical need to subject this asset class to the same stringent risk retention requirements as more distressed asset classes.

Managed CLOs are more akin to private closed-end mutual funds or loan funds than to most types of securitization structures. Such funds also rely solely on their assets for investor

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[88] For a more detailed discussion of the applicability of Section 15G of the Exchange Act to CLOs, *see* Risk Retention for Managed CLOs: Are Regulators Overstepping Their Authority?, White & Case (April 2011).
[89] Available at http://www.lsta.org/WorkArea/showcontent.aspx?id=13144.

returns, as with ABS, but as with CLOs their managers earn fees over time based on asset performance and the amount of assets under management rather than up front in the form of origination fees. These funds are not subject to the risk retention requirements of the proposed rules; because of the functional similarity of the managed CLOs to these types of investment funds, managed CLOs should similarly, not be subject to the proposed rules.

If CLO managers are required to retain the full 5 percent of a CLO's credit risk in the manner contemplated by the proposed rules, we do not believe that most of these managers, especially the independent ones, would have the economic wherewithal to fund this requirement. If it is ultimately determined that CLOs are subject to the risk retention requirements of Section 15G of the Exchange Act and there is no exemption available other than those that have been proposed, we expect that this vibrant market will be severely curtailed, for no credible policy reason.

3. CLO Managers Already Have Skin in the Game

The compensation structure of the manager of a managed CLO already strongly aligns its interests with those of investors. Its fee usually is paid in three tiers, two of which are highly performance-based. A small portion of the "running fee" (ordinarily 10-20 basis points) is paid before the noteholders are paid interest, which permits the collateral manager to cover its fixed costs. However, the remaining portion of the manager's fee (ordinarily 25-40 basis points) is paid after periodic interest payments to noteholders, ensuring that if interest is not being paid, the manager will not receive most of its fee. Most CLOs also feature an additional "incentive fee" paid only when all of the periodic interest payments have been made to noteholders, and the equity holder has received an agreed-upon rate of return. Because this fee structure is so strongly tied to performance and so tightly aligned with the investors' interests, our originator, sponsor and dealer members believe that there is no need to require additional risk retention in managed CLOs.[90]

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[90] If it is ultimately determined that the CLO manager is a sponsor subject to the risk retention requirements of the proposed rules, and if for any reason the CLO is not exempt from the risk retention requirements of the proposed rules (whether because no such exemption is adopted or, if adopted, because the transaction does not meet all of the requirements for the exemption), the compensation payable to the manager after periodic payments to noteholders should count in full as part of the required risk retention, because it so strongly ties the managers' interests with those of investors. *See* Federal Reserve Report at 46-47.

4. If It Is Ultimately Determined that CLOs Are Subject to Section 15G of the Exchange Act, a Safe Harbor for Managed CLOs Should Be Created

For the reasons discussed above, we believe that CLOs are not subject to the risk retention requirements of Section 15G of the Exchange Act. However, if it is ultimately determined that CLOs are subject to the risk retention rulemaking mandate of Section 15G(b)(1) of the Exchange Act, we believe that managed CLOs should be exempt from the risk retention requirements of the proposed rules, so long as they meet reasonable minimum requirements. Our members may have additional comments on a proposed safe harbor exemption for managed CLOs at a later date.

5. If It Is Ultimately Determined that CLOs Are Subject to Section 15G of the Exchange Act, Reasonable Full or Limited Exemptions for Qualifying Commercial Loans Should Be Available

As we discuss more fully below, the exemption from the credit risk retention rules that would be provided by §§ __.17 and __.18 would be of little value as a practical matter, because only a minuscule number of commercial loans originated in the United States meet the stringent requirements proposed for this exemption. By way of example, a recent research report stated that based on just three of the proposed underwriting criteria for qualifying commercial loans,[91] a review of 61 loans contained in CLO portfolios for which information is publicly available showed that only two loans would satisfy these three standards.[92] In addition, most loans included in CLO portfolios have original terms to maturity longer than the five year maximum specified in § __.18 of the proposed rules.[93] As proposed, therefore, the requirements of this exemption are far removed from current market practice.

If it is ultimately determined that CLOs are subject to the risk retention requirements, we would urge that the Agencies consider adopting full and/or partial exemptions from risk retention for commercial loans that satisfy more realistic criteria. Also, as discussed further below, the sponsor of a securitized pool that combines Qualified Assets and non-qualifying assets should be subject to credit risk retention (if at all) only in proportion to the percentage of non-qualifying assets in the pool.

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[91] The three criteria were a total liabilities ratio of 50 percent or less, a leverage ratio of 3.0 or less, and a debt service coverage ratio of 1.5 or greater.

[92] Securitized Market Insights: Risk Retention Proposal: Implications to Securitization, Morgan Stanley (April 6, 2011), at 5 [hereinafter "Risk Retention Implications"].

[93] This proposed limitation on term to maturity appears to be purely arbitrary. We do not understand why a five year loan would be considered to be of higher credit quality than, for example, a loan that matures in seven years.

Finally, the proposed prohibition on any reinvestment period in transactions covered by the qualified commercial loan exemption would make the exemption unavailable to the 95 percent of CLOs that are managed CLOs.[94] We urge that this prohibition be eliminated, if Agencies do not adopt our suggestion of a separate safe harbor exemption for managed CLOs, as it is unclear how reinvestment periods adversely affected the performance of CLOs.

D. Resecuritizations and Similar Transactions

The Agencies have proposed a narrow exemption from the risk retention requirements for resecuritizations, which would be available if a transaction satisfies two requirements: First, the transaction must be collateralized solely by existing ABS issued in a securitization transaction for which credit risk was retained as required under the rules or which was exempted from the credit risk retention requirements of the rules. Second, the transaction must be structured so that it involves the issuance of only a single class of ABS interests and provides for the pass-through of all principal and interest payments received on the underlying ABS (net of expenses of the issuing entity) to the holders.

We ask that an additional exemption be added to § __.21 to cover transactions in which the securities issued are collateralized solely by existing securities that are not subject to the credit risk retention requirements of the proposed rules and any rights or other assets designed to assure timely payments to securityholders. In addition, we ask that the Agencies modify clause (ii) of proposed § __.21(a)(5) in order to permit the issuance of multiple classes of ABS interests under the circumstances described below.

1. Repackagings of Securities Not Subject to the Risk Retention Requirements

As discussed below with respect to repackagings of municipal and corporate debt, we believe that transactions involving repackagings of securities that are not ABS should be exempt from the proposed risk retention rules, subject to such reasonable limitations as the Agencies believe necessary. To the extent that the Agencies are concerned that such an exemption could create an opportunity for avoidance of the risk retention requirements, it may be appropriate to limit the types of securities that could be repackaged in these sorts of transactions to those, such as corporate and municipal bonds, that have historically collateralized such repackagings.

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[94] *See* Risk Retention Implications at 5.

2. *Resecuritizations Involving the Issuance of More than One Class of ABS Interests*

We note that, unlike some types of securitization transactions, resecuritizations often use very simple structures involving a single class of underlying securities or a small number of underlying classes. These can be valuable "de-risking" transactions for institutional holders of the underlying securities whose ratings have been downgraded or that have otherwise become impaired. Resecuritizations can also enhance the proceeds of sale of a class of MBS, or an interest in that class. In some cases, resecuritizations are actually structured by investors. In many resecuritization transactions, a single class of subperforming underlying securities is re-tranched in the resecuritization, allowing the prior holder of the underlying class of MBS to sell a subordinated interest to an investor capable of assessing and pricing that risk while retaining an senior interest of improved credit quality. Alternatively, the prior holder of the underlying MBS may retain the subordinated interest and sell the senior interest to raise cash; or it may sell the senior and subordinated interests to investors having different investment objectives. These transactions have become increasingly useful in the wake of the financial crisis, during which so many classes of RMBS experienced rating downgrades and poor performance.

We recognize that Congress and the Agencies are concerned that perceived past abuses in the market for CDOs of MBS not be repeated. However, it is important that simple, legitimate resecuritization transactions not be tarred with the CDO brush. As described in the Proposing Release:

> in a typical CDO transaction, a securitizer pools interests in the mezzanine tranches from many existing ABS and uses that pool to collateralize the CDO. Repayments of principal on the underlying ABS interests are allocated so as to create a senior tranche, as well as supporting mezzanine and equity tranches of increasing credit risk. Specifically, as periodic principal payments on the underlying ABS are received, they are distributed first to the senior tranche of the CDO and then to the mezzanine and equity tranches in order of increasing credit risk, with any shortfalls being borne by the most subordinate tranche then outstanding.[95]

Unfortunately this broad definition could be read as encompassing some common resecuritization transactions, although most such transactions in recent years have generally involved issuance of ABS collateralized by only a single class or a small number of classes of existing ABS, rather than "many." When the SEC proposed additional ABS regulations in April of 2010, its description of CDOs included the following useful detail: "CDOs often permit the

[95] Proposing Release, 76 Fed. Reg. 24090 at 24138 n. 193.

active management of their pool assets, which could include engaging in activities the primary purpose of which is to protect or enhance the returns of their equity holders."[96] Such active management also sometimes resulted in substantial portfolio turnover, so that a CDO investor may not have known at any particular time what specific MBS the CDO manager had invested in. Unlike CDOs of MBS, however, resecuritizations are not managed vehicles; the pool of underlying securities is fixed on the closing date.

Our originator, sponsor and dealer members believe that the CDO characteristics described above are helpful in distinguishing a CDO of MBS (or other types of ABS) from a typical resecuritization transaction. We ask that the Agencies expand § __.21(a)(5) of the proposed rules to exempt from the risk retention rules resecuritization that involve the issuance of multiple classes of ABS that may differ in payment priority or credit quality. We believe that such an exemption could be effectively limited to typical resecuritization transactions, rather than CDOs, by providing that in such resecuritizations:

- the asset pool could include ABS from no more than three distinct classes, *provided* that the asset pool could include more than three classes of ABS if the issuing entity also owns a security fully guaranteed as to principal by the United States or an agency or instrumentality thereof having an amount payable at maturity equal to or greater than the total principal balance of all ABS issued by the issuing entity;

- the issuing entity could enter into interest rate or currency derivatives, but not credit derivatives; and

- the issuing entity could not acquire additional assets, and could dispose of its assets only in accordance with the terms and conditions of the securitization transaction documents pursuant to which the ABS were issued, and only if the assets are not disposed of for the primary purpose of recognizing gains or decreasing losses resulting from market value changes.

As noted above, in recent years resecuritization transactions have typically involved issuance of ABS collateralized by existing ABS of only a single class or a small number of classes. However, a structure that was common at one time involved pooling of multiple classes of existing ABS, generally of relatively poor credit quality, together with (typically) a single class of U.S. government agency securities, such as zero coupon bonds, providing for payment at maturity in an amount equal to the total principal balance of the ABS issued by the issuing entity. Such ABS issued by the issuing entity were of course risk free as to repayment of principal; the

[96] Asset-Backed Securities, Securities Act Release No. 33-9117, 75 Fed. Reg. 23328, 23332 n. 51 (May 3, 2010).

yield on investment depended on the return on the underlying ABS. We ask that such a structure, which does not share the characteristics of CDOs of MBS described above, be permitted without imposition of an additional layer of risk retention.

E. Repackagings of Municipal Bonds

We expect that SIFMA's Municipal Securities Division will write separately to set forth the views of SIFMA members that are active in the market for municipal financial products such as tender option bonds. That letter would explain in detail the nature of these products, and importantly that they are not the type of product intended to be covered by the risk retention requirements of Section 15G of the Exchange Act, and therefore should not be subject to the risk retention requirements applicable to typical asset-backed securities. SIFMA members active in the securitization markets urge the Agencies to carefully consider their arguments.

F. Repackagings of Corporate Debt

Corporate debt repackagings typically involve the deposit of corporate debt securities, generally having an investment grade credit rating, into a trust that issues a single class of securities that is entitled to the cash flows from the underlying bonds. The underlying corporate debt securities are acquired in the secondary market by the sponsor of the repackaging transaction in purchase transactions in which the underlying obligor is typically not involved and of which the underlying obligor would typically be unaware. Frequently the underlying bonds are obligations of a single obligor, and in many cases are all of the same class. In some transactions the trust also holds an interest rate swap or currency swap, and the securities issued have an interest rate that differs from that of the underlying bonds, or are denominated in a different currency. The securities issued by the trust are generally issued and exchangeable in smaller denominations than the underlying bonds, and in many cases are offered pursuant to a shelf registration statement.

As stated in the Proposing Release, one of the key goals of the skin-in-the-game requirements of Section 15G of the Exchange Act is to provide securitizers "an incentive to monitor and ensure the quality of the assets underlying a securitization transaction, and thereby help . . . align the interests of the securitizer with the interests of investors."[97] However, because there is no relationship between the sponsor of a corporate debt repackaging and the issuer of the underlying obligations, a repackaging of the debt securities of any particular corporate issuer will have no effect on the terms of the underlying obligations or the creditworthiness of the obligors.

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[97] *Id.*

Because the underlying bonds in a repackaging of corporate debt are not themselves asset-backed securities, and would therefore not be subject to the proposed risk retention requirements or expressly exempt from these requirements, securities issued in a corporate debt repackaging would not be exempt from the proposed risk retention rules under § __.21 in its proposed form. Proposed § __.21(a)(5) would exempt certain resecuritizations, but only if the securities that are issued are collateralized solely by ABS that were either subject to, or expressly exempted from, the risk retention rules.[98] Subjecting corporate debt repackagings to risk retention would be an anomalous result. To state the obvious, corporate debt obligations are, generally, full recourse obligations of the issuing company. The issuer of the corporate bonds bears 100 percent of the credit risk. The corporate issuer could not retain an additional 5 percent even if it were inclined to do so. To add an additional layer of risk retention to a repackaging of obligations that are themselves the subject of 100 percent risk retention by requiring the sponsor of the repackaging transaction to retain an additional 5 percent of the credit risk would benefit no one, and we do not believe that Congress intended this result.

We ask that an additional exemption be added to § __.21 to cover transactions in which the securities issued are collateralized solely by (1) existing securities that are not subject to the credit risk retention requirements of the proposed rules and (2) any rights or other assets designed to assure timely payments to securityholders. To the extent that the Agencies are concerned that such an exemption could create an opportunity for avoidance of the risk retention requirements, it may be appropriate to limit the types of securities that could be repackaged in these sorts of transactions to those, such as corporate obligations (and municipal bonds, as discussed above), that have historically collateralized such repackagings.

Securities issued in repackagings of corporate debt are *not* CDOs and are not analogous to CDOs, particularly CDOs of MBS of the type whose performance has been a subject of Congressional and regulatory concern. Any credit rating assigned to such securities is based primarily or exclusively on the rating assigned to the underlying corporate obligations. The structures are straightforward and transparent. We can see no policy rationale for requiring additional retention of credit risk on securities backed by full recourse corporate obligations. We urge the Agencies to exempt repackagings of corporate debt from risk retention under §__.21.

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[98] As noted above, §__.21(a)(5)(i)(B) of the proposed rules refers only to underlying securities that were exempt from the risk retention rules "pursuant to subpart D of this part," and not to underlying securities that are not asset-backed securities and therefore not subject to the risk retention rules at all.

IX. Qualified Assets

A. Qualified Residential Mortgages

There is no better example of an aspect of the proposed risk retention rules where a detailed, thorough, and patient economic and social analysis of the impacts of the regulations is needed than this: the proposed eligibility criteria for qualified residential mortgages. We urge the Agencies to reconsider the proposed QRM standards in light of the various factors described in this letter and re-propose criteria that will satisfy the standard set by Section 15G of the Exchange Act while fostering the recovery of the residential mortgage market. The final rules should be designed to stand the test of time.

The Proposing Release states that in developing the proposed QRM criteria the Agencies reviewed data from multiple sources, including information on loans purchased or securitized by the GSEs. The Agencies concluded that academic literature and other evidence supports the view that loans that meet the proposed QRM standards would have "low credit risk even in stressful economic environments." While that may be true, we believe that merely identifying a mortgage loan gold standard based on abstract considerations is insufficient. The analysis needs to explore what the designation of a particular segment of the market to be served by QRMs would mean for borrowers, housing markets, and the national economy.

The analysis must take into account the final form of the risk retention requirements that will be applicable to securitizations of residential mortgage loans that do not meet the QRM standards – particularly the premium capture provisions, which as we have noted could have substantial impact on the non-GSE RMBS markets. The more onerous the premium capture provisions are, and therefore the more that those provisions would operate to discourage securitization of residential mortgage loans subject to risk retention, the greater the significance of the QRM exemption will be to the RMBS markets.

The analysis must also consider a reduction of the currently outsized role of the GSEs in the residential mortgage markets. It is clear that the current state of mortgage finance in the U.S., in which the Federal Government's market share is grossly disproportionate to that of private funding, must change. This change may impact mortgage lending in significant ways. Therefore any impact analysis must contemplate how large future private RMBS markets will be, and their relative levels of liquidity and cost. Additionally, the analysis must take into account the impact of the myriad other regulatory changes that will affect mortgage lenders, including but not limited to Basel III and its impact on bank capital requirements and balance sheet management concerns, along with the interaction of existing rules such as accounting standards. An appropriate impact analysis of the QRM provisions must be multi-faceted and inclusive of the

litany of important changes faced by the markets. It is not clear from the discussion in the Proposing Release that such an analysis has been conducted.

Our specific concerns regarding the proposed QRM underwriting and servicing standards are described below.

1. The Underwriting Standards

We believe that the proposed QRM eligibility criteria reflect a basic misunderstanding of the loan underwriting process. The QRM standards would create a siloed underwriting environment, in which each criterion of borrower creditworthiness would exist separately and would not affect any other criteria. In reality, all of the underwriting factors interact with one another, and the QRM criteria should reflect this.

We are very concerned that narrow, inflexible QRM criteria will stifle residential mortgage lending – or force borrowers into non-QRM loans, which will offer less favorable terms. The QRM eligibility criteria should permit lenders a degree of flexibility whereby creditworthiness factors can be considered in combination, and a particular criterion may be altered if compensated for by another. § __.15 should outline a baseline requirement for QRM eligibility and allow limited variation when one or more factors exceed, in a credit-positive manner, the baseline requirement. Although we understand that permitting flexibility in loan underwriting will inevitably introduce an element of additional complexity in administration, we believe that this can be accomplished in a manner that can be adequately monitored. The benefit of this approach would be to create more equitable outcomes for origination – a borrower making a substantial down payment, for instance, creating an LTV lower than required, would not be penalized because his or her total debt-to-income ratio is two or three percent higher than the baseline.

This sort of careful, individual loan underwriting is how mortgage loans should be made.

<u>The Borrower's Debt-to-Income Ratio</u>. The most important DTI ratio is a borrower's total, or "back-end," debt-to-income ratio, which measures how much of a borrower's gross (pre-tax) monthly income would go toward payment of monthly mortgage and non-mortgage debt obligations. The recent financial crisis has proven this point, as mortgage borrowers have more frequently than expected chosen to pay, for example, their auto loans before their credit cards, and either of those before their mortgage loans.[99] The front-end DTI ratio, which measures how

[99] *See, e.g.,* Who's Getting Paid During the Subprime Crisis?, Equifax (May 2008); Strategic Default on First and Second Lien Mortgages During the Financial Crisis, Federal Reserve Bank of Philadelphia (December 2010); TransUnion Study (February 2010);ABS Market Insights: Understanding Strategic Defaults, Morgan Stanley (April

much of a borrower's gross (pre-tax) monthly income is represented by the borrower's required payment on a first-lien mortgage loan, is a less significant predictor of delinquency than the back-end DTI ratio, as the demands of a borrower's other debts impact mortgage payment performance.

In our view, the proposed DTI criteria are overly conservative. We believe that a more appropriate baseline maximum back-end DTI ratio is in the range of 42 to 45 percent, rather than the strict 36 percent that has been proposed. We believe that a baseline maximum front-end DTI ratio of 32 percent is more appropriate than the 28 percent that has been proposed.

We also request that the meaning of the terms "total monthly debt" and "debt obligation," as used in § __.15(d), be clarified.[100]

The Loan-to-Value Ratio. The 80 percent LTV requirement presents an acceptable baseline for a gold standard mortgage loan – if that is indeed the intention of regulators. As the Agencies explained in the Proposing Release, the level of equity held by borrowers is an important predictor of default. On the other hand, there are substantial social implications to an across-the-board 20 percent down payment requirement for a mortgage loan to qualify as a QRM. We expect that the Agencies may receive more comments on this one point than on any other, so we will be brief. This criterion, like others, is too strict for the current condition of the mortgage market. The Agencies do not write on a blank slate in this regard – home prices are falling, borrowers are struggling, and financing for would-be home buyers is sometimes unavailable. Consistent with what we have suggested above regarding trade-offs among underwriting criteria and the need for a more inclusive and rigorous analysis of impact, we believe that a re-proposal of the QRM eligibility criteria is essential in order that the market may comment on not only the findings of the Agencies' analysis, but also the factors and process that led to those findings.

Consistency between the "Qualified Residential Mortgage" and "Qualified Mortgage" Definitions. Whatever shape the precise terms of the QRM eligibility criteria may ultimately take, we believe that it is important that the definition of what constitutes a QRM be consistent with the definition of a "qualified mortgage" under Regulation Z that will provide a safe harbor from liability, not merely a rebuttable presumption of compliance with the ability to repay requirement. In practice, mortgage loans that carry significant risk of assignee liability are rarely made and even more rarely securitized. Without regard to the exemption from the credit risk

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2010); Risk Weighting of Auto Loans, Grant Thornton and Auto Finance Council (2011); U.S. Asset-Backed Securities Have Maintained High Credit Stability And Low Default Rates Since 1983, Standard & Poor's (May 27, 2011).

[100] By way of comparison, the term "total debt," as used in §§ __.18 - 20, is clearly defined in § __.16.

retention requirements, a QRM that does not qualify as a safe harbor qualified mortgage would carry too much legal risk for securitizers.

Verification of QRM Compliance. Certain of the proposed QRM requirements may be difficult for purchaser to verify. For example, it may not be possible for a securitizer to determine whether, "to the creditor's knowledge," other liens existed at the closing of the mortgage transaction, or whether the creditor subsequently obtained a credit report containing information contrary to that in a prior credit report. A securitizer of QRMs that was not itself the originator should be permitted under § __.15 to rely upon representations made by the creditor as to compliance with the QRM criteria.

Seasoning. Under the proposed QRM eligibility criteria, whether a loan qualifies as a QRM is generally determined as of the closing of the mortgage loan, without regard to the loan's future payment performance. So, for example, if a borrower under a particular mortgage loan did not satisfy one of the QRM creditworthiness criteria at closing but subsequently demonstrates creditworthiness through an extended period of timely payment, that mortgage loan could, notwithstanding the borrower's history of timely payment, never qualify as a QRM. We believe that seasoning of loans – an important factor on evaluating a loan pool's credit quality – should be an element of the QRM criteria.

2. The Servicing Standards

There is nothing in Section 15G of the Exchange Act that requires or authorizes the inclusion of servicing standards in the QRM criteria, or that suggest that such should be included.[101] We are keenly aware of the significance of the role that mortgage servicers play, and we recognize the interest of the Federal Government in promulgating servicing standards. But the risk retention rules are not the place for such an undertaking, and the vague servicing standard proposed as part of the QRM criteria would do more harm than good. Servicing standards, if developed, should apply to all servicers, and be developed through a separate consultative process. Servicing is a critical component of the performance of many securitized assets, and it deserves careful, undivided attention.

As proposed, §__.15(b)(13) of the proposed rules would require that a mortgage originator that sought to satisfy the QRM criteria must include terms in the mortgage transaction documents under which the creditor commits to have servicing policies and procedures under which the creditor will mitigate the risk of default by taking loss mitigation actions, such as loan

[101] The Agencies are directed to jointly define the term "qualified residential mortgage," taking into consideration "underwriting and product features that historical loan performance data indicate result in a lower risk of default." § 15G(e)(4)(B).

modification, if at any time the estimated net present value resulting from such action would exceed the estimated net present value of recovery through foreclosure. This commitment does not appear to be conditioned in all cases on the borrower's first having become delinquent in payment or otherwise demonstrated that he or she is facing any financial difficulty.[102] The mortgage transaction documents would also be required to include a commitment to take loss mitigation actions if the borrower became 90 days delinquent in payment, as well as other provisions. At a minimum, if these provisions are not removed from the final rules, any loss mitigation activity should be conditioned on a determination by the servicer that the loan is in default or that default is, absent loss mitigation actions, reasonably foreseeable.

First, including servicing provisions in the QRM criteria is completely unnecessary. As noted by the Agencies in the Proposing Release, federal regulators expect to propose national mortgage servicing standards within months:

> [T]here is an ongoing interagency effort among certain Federal regulatory agencies, including some of the Agencies joining in this proposed rulemaking, to develop national mortgage servicing standards that would apply to servicers of residential mortgages, including bank and bank-affiliated servicers and servicers that are not affiliated with a bank. These standards would apply to residential mortgages regardless of whether the mortgages are QRMs, are securitized or are held in portfolio by a financial institution. The primary objective of this separate interagency effort is to develop a comprehensive, consistent, and enforceable set of servicing standards for residential mortgages that servicers would have to meet. In addition to servicing matters covered in this proposal, the separate interagency effort on national mortgage servicing standards is taking into consideration a number of other aspects of servicing, including the quality of customer service provided throughout the life of a mortgage; the processing and handling of customer payments; foreclosure processing; operational and internal controls; and servicer compensation and payment obligations. The agencies participating in this separate effort currently anticipate requesting comment on proposed

[102] *See* §__.15(b)(13)(i)(A) of the proposed rules. In connection with the development of national mortgage servicing standards, as described in the Proposing Release, we urge the Agencies to consider the potential consequences very carefully before proposing such a loss mitigation standard. We respectfully submit that compelling mortgage lenders to make loss mitigation commitments that may be viewed by borrowers as, in effect, writing an insurance policy to each borrower guaranteeing that the mortgage payment will be reduced if the value of the mortgaged property declines, could substantially increase the cost of obtaining a residential mortgage loan in many areas of the United States, particularly those that have experienced, or where there is reason to anticipate, significant declines in property values. We note that the proposed standard does not provide for any limitation on the number of times that such a modification would need to be effected. We believe that a regulatory action mandating a servicing standard such as this could fairly be described as reckless.

> standards later this year, with the goal of having final standards issued shortly afterward.[103]

Including separate servicing standards as part of the QRM criteria creates a risk that these standards will conflict in some way with the national standards to be proposed later in 2011.

Second, even if it were prudent to include servicing standards as part of the QRM criteria, QRM borrowers are the least likely to benefit from additional commitments by lenders with respect to loss mitigation. As stated in the Proposing Release, the underwriting standards and product features for QRMs are intended to ensure that these mortgage loans "are of very high credit quality." In other words, QRMs will be the least likely residential mortgage loans to default.

Third, as proposed the QRM servicing standards are too vague for effective compliance. Under §__.15(b)(13) of the proposed rules, a mortgage originator would be required, for example, to include terms in the mortgage transaction documents under which the creditor commits to have servicing policies and procedures under which the creditor will implement or maintain "servicing compensation arrangements consistent with" the originator's loss mitigation commitments. We respectfully submit that we do not know what servicing compensation arrangements would be judged by the Agencies to be consistent with those commitments. This one aspect of the servicing standards could itself be the subject of a detailed rulemaking. Without clear regulatory guidance, a lender could be subject to potential legal action by borrowers professing a different view of what servicing compensation arrangements would have been more appropriate. Similarly, a mortgage originator would be required to include terms in the mortgage transaction documents under which the creditor commits to have servicing policies and procedures under which the creditor will "[i]mplement procedures for addressing any whole loan owned by the creditor (or any of its affiliates) and secured by a subordinate lien on the same property that secures the first mortgage loan if the borrower becomes more than 90 days past due on the first mortgage loan." What is intended here is unclear. The intended meaning of "addressing" in this context could be a subject of endless dispute and litigation.

Fourth, adding an explicit provision to a promissory note or mortgage that may be read by a borrower as committing the lender to a future loan modification if the value of his home declines would exacerbate the moral hazard risk already prevalent in the residential mortgage market – not a development that would be conducive to recovery of that market.

[103] Proposing Release, 76 Fed. Reg. 24090 at 24127.

To the extent that the proposed QRM servicing standards are consistent with national servicing standards to be proposed later this year, the QRM servicing standards would be duplicative and unnecessary. To the extent that the QRM servicing standards would be less strict than the national standards, they would be meaningless. To the extent that the QRM standards would be more strict than the national standards, that would be a highly illogical result given the high credit quality of QRMs. And unlike national servicing standards imposed by regulation and subject to revision by the applicable government agencies, servicing standards embedded in promissory notes, mortgages or deeds of trust would be, as a practical matter, virtually impossible to amend on a loan-by-loan basis, even if it were possible to do so without jeopardizing a sponsor's exemption from the credit risk retention requirements.

We urge that the proposed QRM servicing standards be withdrawn.

3. Possible Alternative Approach to the QRM Exemption

We note the Agencies' request for comment on a possible alternative approach to implementing the exemption for QRMs from the risk retention rules, which would generally involve broadening the QRM definition while making the risk retention requirements stricter for securitization of non-QRMs. However, as we have discussed, both the proposed baseline QRM criteria and the proposed risk retention requirements for non-QRM securitizations are already too strict. After the proposed QRM standards have been adjusted to more realistically reflect loan underwriting practices, and after the proposed risk retention requirements have been modified to remove the premium capture provisions and provide necessary flexibility in implementation, then we believe that an alternative approach may be something that could be usefully explored.

B. Qualifying Automobile Loans

The range of types of loans that would qualify as qualifying auto loans is very narrow, and we ask that the Agencies expand this list in reasonable ways. Loans to finance purchase of motorcycles should be included, as should loans to finance vehicles purchased for commercial use, whether the borrowers are individuals or businesses. We do not understand why appropriately underwritten auto leases are not included in this category as proposed, and we urge the Agencies to correct this omission.

As is the case for other types of Qualified Assets, the proposed underwriting criteria for qualifying auto loans are unrealistically restrictive. In fact, they resemble residential mortgage underwriting criteria in significant respects. As an absolute minimum step toward making the qualifying auto loan criteria more reasonable, the required down payment for a qualifying auto

loan should be reduced far below 20 percent; a 20 percent down payment would be atypical in the auto market.

The proposed requirement that the holder of the loan or its agent maintain physical possession of the title for the related vehicle is contrary to the laws of several states, and should be eliminated. Multiple states require that the borrower hold the certificate of title.

We recommend that the Agencies adopt alternative, more realistic and inclusive criteria for securitizations of auto loans that would subject the sponsor to a more limited credit risk requirement, such as 2.5 percent.

C. A Reduced Risk Retention Requirement for Loans that Satisfy More Realistic Standards for Credit Quality

Section 15G(c)(1)(B)(ii) of the Exchange Act provides that a sponsor shall be required to retain less than 5 percent of the credit risk of the securitized loans if the ABS are collateralized by loans that meet underwriting standards prescribed by the Banking Agencies. The Agencies elected not to propose any underwriting standards to support a risk retention requirement between zero and 5 percent because, as stated in the Proposing Release, the Agencies were concerned that such a standard "may not sufficiently incent securitizers to allocate the resources necessary to ensure that the collateral backing an ABS issuance satisfies the proposed underwriting standards."[104] We disagree, and we urge the Agencies to reconsider.

A limited exemption from the risk retention requirements may be very important to some securitizers in view of the extremely strict approach taken by the Agencies in proposing underwriting standards for Qualified Assets. CLOs[105] and CMBS transactions, in particular, could potentially benefit from such a partial exemption from the risk retention requirements. We recommend that the proposed rules provide for retention of not less than 2.5 percent of the credit risk to the extent that a securitized pool consists of commercial real estate loans or commercial loans originated in accordance with alternative underwriting criteria that are less strict than those that would be required for complete exemption from the risk retention rules. We believe that more realistic and inclusive underwriting standards could be developed through a careful review of the relevant markets.

[104] Proposing Release, 76 Fed. Reg. 24090 at 24130.

[105] Assuming, for purposes of discussion, that CLOs should even be subject to credit risk retention. As discussed above, the terms of Section 15G of the Exchange Act do not appear to encompass CLOs. Further, we believe that managed CLOs should be exempt from the risk retention requirements.

D. Partial Risk Retention for Pools that Consist in Part of Qualified Assets

The risk retention requirements for sponsors of securitization transactions that include Qualified Assets should be based on the portion of the asset pool that does not satisfy the applicable Qualified Asset criteria. For example, if a securitized pool of $100 million of auto loans consists of $60 million of qualifying auto loans and $40 million of non-qualifying loans, the risk retention requirement for that pool should be equal to 5 percent of $40 million, or $2 million. This regime would be easy to administer and enforce and transparent to investors. We urge the Agencies to adopt this simple but consequential change.

As we have noted elsewhere in this letter, the criteria for qualification as a Qualified Asset are very strict – in some cases, unreasonably so. Even if these criteria are modified to make them more useful to originators and securitizers, the standards will remain high. If a securitizer must wait until it has assembled a "critical mass" of Qualified Assets sufficient to support an ABS offering by itself, the liquidity of these loans could be significantly impaired, the originator would bear the cost of holding and financing those loans, and the origination of Qualified Assets would therefore be discouraged. We believe that the risk retention rules should be designed to encourage, rather than discourage, origination of higher quality loans, and that the change we recommend will be a step in that direction.

X. Exemption of Securitizations of FFELP Loans

We appreciate the effort made by the Agencies to provide for appropriate exemptions from the credit risk retention requirements. However, there are additional exemptions that we believe are appropriate, and we urge the Agencies to modify §__.21 of the proposed rules to exempt these transactions from the risk retention regulations.

For more than four decades, student loans were originated under the Federal Family Education Loan Program (the "FFEL Program" or "FFELP"), under which loans funded by private lenders were guaranteed by designated state agencies and reinsured by the Federal Government. Effective July 1, 2010, President Obama and Congress eliminated this program in favor of direct federal lending. However, many thousands of FFELP loans remain outstanding.

FFELP loans were authorized under Title IV of the Higher Education Act of 1965.[106] The FFEL Program was subject to reauthorization every six years.

[106] 20 U.S.C. §§ 1001 *et seq.* (2006), *amended by* Pub. L. No. 110-230 (Apr. 30, 2008) [hereinafter the Higher Education Act].

FFELP loans were originated by commercial banks, savings-and-loan associations, credit unions, pension funds, certain non-profit organizations and state agencies. The loans are guaranteed for 100 percent of principal and accrued interest against death, disability, discharge in bankruptcy or the crime of identity theft. Loans originated prior to October 1, 1993 are guaranteed as to 100 percent of principal and accrued interest if the borrower defaults; those originated on or after October 1, 1993 but before July 1, 2006, are guaranteed as to 98 percent of principal and accrued interest if the borrower defaults; loans originated on or after July 1, 2006 but before July 1, 2010, are guaranteed as to 97 percent of principal and accrued interest if the borrower defaults.

The U.S. Department of Education (the "DOE") reinsures a substantial portion of the guarantor's risk. The maximum rates of loss reimbursement are 100 percent for loans originated prior to October 1, 1993 (and certain loans that qualify for special treatment); 98 percent for loans originated between October 1, 1993 and September 30, 1998; and 95 percent for loans originated on or after October 1, 1998. The rate of loss reimbursement declines if the default rate of student loans guaranteed by a particular guarantor exceeds certain specified levels.

There are various types of FFELP loans, including subsidized and unsubsidized Stafford loans, made on the basis of economic need; Parent Loans for Undergraduate Students, to parents of dependent children who were students in undergraduate programs and whose costs of attending school exceeded the amount of financial aid available from other sources; and consolidation loans that enabled borrowers to combine multiple loans into a single loan while locking in a fixed interest rate and reducing monthly payments by extending the loan's maturity to as long as 30 years.

Notwithstanding the fact that most of the credit risk associated with each FFELP loan is guaranteed by a state agency and reinsured by an agency of the Federal Government, the credit risk retention rules as proposed would require that a sponsor satisfy the risk retention requirements in any securitization of FFELP loans after the effective date of the new rules. We believe that this is an inappropriate result, and we ask the Agencies to revise §__.21 of the proposed rules to exempt securitizations of FFELP loans.

Section 15G(c)(1)(G)(ii) of the Exchange Act requires that the risk retention regulations provide for "a total or partial exemption for the securitization of an asset issued or guaranteed by the United States or any agency of the United States," as the Agencies jointly determine to be "appropriate in the public interest and for the protection of investors." In light of the exemptions from the risk retention requirements provided for other securitizations for which less credit

protection is provided,[107] we believe that it is wholly consistent with the public interest and investor protection not to impose a risk retention requirement on a transaction in which ABS are backed by assets that are 97 percent (or more) guaranteed by a state agency and 95 percent reinsured by an agency of the United States government. We also believe that such an exemption would be consistent with Congressional intent, in view of the exemption provided under Section 15G(e)(3)(B) of the Exchange Act, which operates to exempt securitizations of mortgage loans that are substantially less than 100 percent federally insured or guaranteed.[108]

XI. Treatment of Fannie Mae and Freddie Mac

As noted in the Proposing Release, because Fannie Mae and Freddie Mac (the "GSEs") fully guarantee the timely payment of principal and interest on their MBS, they are exposed to the entire credit risk of the underlying mortgage loans. Given that "FHFA's conservatorship of the [GSEs] is directed toward minimizing losses, limiting risk exposure, and ensuring that the [GSEs] price their services to adequately address their costs and risk," and that the United States government has entered into arrangements "to provide support to the relevant [GSE] should the [GSE] have a net worth deficit as a result of the [GSE's] guaranty of timely payment on the asset-backed securities it issues,"[109] the Agencies deemed it appropriate to exempt securities issued by the GSEs from the risk retention requirements of the proposed rules. Therefore, the proposed rules exempt securities that are fully guaranteed as to principal and interest by a GSE from their risk retention requirements for so long as the relevant GSE is operating under the conservatorship or receivership of the FHFA, and securities similarly guaranteed by any successor to an Agency that is similarly regulated, so long as the Agency or successor is operating with capital support from the United States. We support this exemption as proposed.

To the extent that the goal of imposing an additional risk retention requirement might be to ease mortgage markets away from GSE domination, we support the consideration of other

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[107] We note, for example, that pursuant to Section 15G(e)(3)(B) of the Exchange Act, which provides for the exemption of "any residential, multifamily, or health care facility mortgage loan asset, or securitization based directly or indirectly on such an asset, which is insured or guaranteed by the United States or an agency of the United States," the Agencies have provided in proposed Section §__.21(a)(1)(i) for exemption of such transactions as securitizations of mortgage loans insured by the Federal Housing Administration (the "FHA") or guaranteed by the Department of Veterans Affairs (the "VA") or the Department of Agriculture Rural Development ("Rural Development"). As noted in the Proposing Release, while the FHA insures the lender at approximately 100 percent of losses including advanced taxes, insurance and foreclosure costs, the VA guarantees "between 25 percent and 50 percent of lender losses in the event of residential borrower defaults," and Rural Development "guarantees a sliding amount against loss of up to 90 percent of the original loan amount for single family loans." Proposing Release at 24136.

[108] *See id.*.

[109] Proposing Release, 76 Fed. Reg. 24090 at 24112.

methods that we believe would be more directly targeted to this result. For example, the conforming loan limit changes that will become effective soon[110] will begin to redefine the market in which the GSEs operate and could be furthered at a responsible pace; guarantee fee adjustments could help align the economics of securitization by GSEs with that of private market participants; and capital requirement changes for the GSEs could help to align the economics of the GSEs' guaranty with those of banks that already need to retain risk and hold capital against retained risk. Taking steps such as these, in a coordinated and measured manner, would allow for the "rightsizing" of the GSEs' share of the mortgage securitization markets, while remaining mindful of the significant negative impact that would result from a sudden withdrawal of the GSEs from mortgage finance. We note that all of this must be done, however, in a manner mindful of the impact of other aspects of the proposed rules, and general economic conditions, on the fragile housing markets.

The economic impact of the GSEs' guaranty of their MBS is equivalent to retention of 100 percent of the credit risk of the assets underlying those securities. This is 20 times the base risk retention requirement of the proposed rules, and therefore 20 times the maximum risk retention that would be required of any private market securitizer. Because the GSEs already retain 100 percent of the credit risk of the assets they securitize, an additional, separate 5 percent "risk retention" holding through one of the means permitted by the proposed rules would not, in economic reality, mean that the GSEs would be retaining any additional risk. Nor would it serve in any manner to realign the incentives of the GSEs toward their investors, as those risks already are directly aligned as a result of the existing guaranty. The only result would be to add an economic cost to be borne by the GSEs, which would reduce the efficiency of their securitizations. This cost ultimately would be borne by consumers in the form of higher mortgage costs, and taxpayers, in the form of reduced efficiency of the GSEs themselves.

Requiring an additional 5 percent risk retention through one of the methods permitted by the proposed rules would add significant assets to the GSEs' balance sheets, when multiple other initiatives are driving toward the opposite outcome.[111] According to the Proposing Release, aggregate GSE mortgage originations were approximately $939 billion in 2005, $887 billion in 2006, $1.027 trillion in 2007, $793 billion in 2008 and $1.176 trillion in 2009.[112] If we assume,

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[110] Available at http://www.fhfa.gov/Default.aspx?Page=185.

[111] For example, the Obama administration's plan to reform the housing markets would "responsibly reduce the role of [the GSEs] in the mortgage market and, ultimately, wind down both institutions." Department of the Treasury and U.S. Department of Housing & Urban Development., Reforming America's Housing Finance Market: A Report to Congress, at 2 (Feb. 2011) (the "Administration's Housing Finance Report"), available at http://www.treasury.gov/initiatives/Documents/Reforming%20America%27s%20Housing%20Finance%20Market.pdf.

[112] Proposing Release, 76 Fed. Reg. 24090 at 24141.

based on historical figures with a possible decrease as a result of winding-up efforts, that mortgage originations securitized by the GSEs in the coming years will approximate $500 billion to $1 trillion annually, then imposing an additional 5 percent risk retention requirement on the GSEs would result in between $25 billion and $50 billion of assets that would be required to be added to (or would not be permitted to be rolled off of) their balance sheets every year. If the GSEs were not permitted to hedge or transfer these positions, as is generally provided by the proposed rules, the residual balance sheet effect of the next three years of securitization by the GSEs could extend for decades. It is not clear who would fund these balance sheet items in the event that the GSEs' government subsidies (or even the GSEs themselves) are eliminated.

If the GSEs were subjected to the risk retention requirements of the proposed rules, one way for them to comply without triggering the adverse balance sheet effects described above might be for them to utilize the vertical risk retention option or horizontal risk retention option, and then to allocate that risk to the originators of the securitized loans. However, this approach would have several drawbacks. First, under the proposed rules, this would only be available to the extent that any particular originator originated at least 20 percent of any securitized asset pool. Second, in many cases the originator of loans securitized by the GSEs is not the entity selling them to the Agencies – rather, the loans are first acquired by an institution such as a large bank, which then aggregates the loans for sale to the GSEs. In this scenario, only the original creditor could be allocated any of the required risk retention, unless the Agencies modify their interpretation of the meaning of "originator" as discussed above. Third, many of the originators of loans sold to the GSEs are smaller institutions that rely on the GSEs to support mortgage lending and are unlikely to be able to execute private-label securitizations on their own, due to their smaller volume of origination and the typical large size of an RMBS transaction.[113] In our view, smaller originators are not likely, in the near term, to have the balance sheet capacity to absorb five percent of their current loan production volumes. Therefore, even if all of the required risk retention could be allocated to the loan originator, this solution would unduly limit the U.S. markets' loan origination capacity.

Another means for the GSEs to comply without triggering the adverse balance sheet effects described above would be for them to limit their mortgage business to origination of QRMs. This would address the balance sheet capacity issues described above. However, as described in the Proposing Release, only a small percentage (at most approximately 31 percent) of the mortgage loans purchased by the GSEs over the past few years would have qualified as QRMs.[114] Therefore, if the QRM exemption were adopted as proposed, reliance by the GSEs on

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[113] *See, e.g.,* Testimony of Independent Community Bankers of America, April 14, 2010: "Though very different in key respects, all three housing GSEs provide community banks with irreplaceable access to money markets," *available at* http://www.icba.org/files/ICBASites/PDFs/test041410.pdf.
[114] Proposing Release, 76 Fed. Reg. 24090 at 24141.

that exemption for any risk retention obligation would immediately, sharply, and negatively impact the availability of credit to consumers. Given the drastically reduced capacity of the private securitization markets over the past few years, it is unclear how quickly those markets would be able to pick up the slack left by the retreat of the GSEs.

We also note that if the GSEs were subjected to the risk retention requirements of the proposed rules, if and to the extent that the GSEs continued to purchase non-QRM mortgage loans and the QRM exemption were adopted as proposed, we believe it likely that the GSEs would securitize QRMs separately from non-QRM mortgage loans in order to take advantage of the exemption for securitizations of QRMs.[115] This would split the GSE MBS markets into two segments for each of Fannie Mae and Freddie Mac, for a total of four separate GSE MBS markets. This would lower overall liquidity in the GSEs' MBS markets, which would in turn negatively affect both the value of those MBS and ultimate pricing and credit availability for mortgage borrowers.

XII. Required Disclosure to Investors and Regulators

We recognize the importance of providing clear disclosure to investors regarding the sponsor's risk retention obligations with respect to a securitization transaction and how those obligations will be satisfied, and we support many of the proposed disclosure requirements. However, the proposal that the dollar amount of risk exposure required to be retained and actually retained be disclosed prior to the sale of the ABS would be difficult to comply with in practice. We believe it should be sufficient to disclose prior to the sale of the ABS the percentage and estimated dollar amount of credit risk required to be retained and actually retained, and we ask that the rules be revised to reflect this change.

Each of §§__.4 through __.10, __.12 and __.13 requires that the sponsor disclose certain information to potential investors "a reasonable period of time prior to the sale" of the ABS. This information includes, generally, the amount (expressed as a percentage and dollar amount) of the ABS interests that the sponsor or another party will retain (or did retain) or that will be (or was) deposited in a reserve account at the closing of the transaction, as well as, in some cases, a description of the material terms of the ABS interests to be retained. Sponsors would be required to make this disclosure available to the applicable Agencies upon request.

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[115] As discussed above, we have asked the Agencies to revise the terms of the QRM exemption to permit partial risk retention by sponsors of securitization transactions that include a portion of non-QRM loans.

Under the federal securities laws, the term "sale" includes any contract of sale.[116] In many ABS offerings, although the material terms of the offered securities are substantially final prior to the time of sale, certain terms may be subject to change between the time that investors enter into contracts of sale and the closing of the securitization transaction. In particular, the aggregate dollar amount of the underlying asset pool, and therefore the dollar amounts of the classes of ABS, may change. This may occur due to, for example, removal of one or more pool assets due to discovery of a breach of representation or warranty. To the extent that the aggregate dollar amount of the asset pool changes prior to closing, the principal amounts (or par values) of the ABS would change proportionately. The possibility that the final dollar amounts of the pool assets and the ABS may differ from what has been described in preliminary disclosure documents is disclosed to investors.

We believe that it would be sufficient for sponsors to disclose to prospective investors the actual percentage of each ABS interest that will be required to be retained under the risk retention rules and that the sponsor (or other party) expects to retain as of the closing date, together with the estimated dollar amounts of such retention, based upon the approximate dollar amounts of the asset pool and ABS that appear in the disclosure document provided to prospective investors prior to the sale of the ABS. Similarly, in the case of a horizontal cash reserve account or premium capture cash reserve account, it would be sufficient to disclose to prospective investors the estimated amount that will be deposited in such accounts based upon the actual percentage of the estimated par value of the ABS interests, in the case of a horizontal cash reserve account, or the estimated gross proceeds and estimated par value of the ABS interests, in the case of a premium capture cash reserve account.

If the information described above is provided to investors prior to the sale of the ABS, we believe that the actual dollar amounts of ABS interests that will be retained or cash that will be deposited would be immaterial. Prospective investors who receive the information described above will have received a clear description of the amount of risk to be retained. We believe that it would be sufficiently clear to investors that if the size of the asset pool changes prior to the closing date and the sizes of the ABS change proportionately, there will be a proportionate change in the amount of risk retained or funded. If deemed necessary by the Agencies, the final rules could provide that following the closing of the transaction the final dollar amounts of risk exposure retained or funded must be disclosed to investors.

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[116] *See* § 2(a)(3) of the Securities Act. *See also* Securities Offering Reform, Securities Act Release No. 33-8591, 70 Fed. Reg. 44722, 44765 n. 391 (Aug. 3, 2005)., stating that "[c]ourts have held consistently that the date of a sale is the date of contractual commitment, not the date that a confirmation is sent or received or payment is made."

XIII. Treatment of Assets Originated or Issued Prior to Effectiveness of the Risk Retention Rules

As proposed, the credit risk retention rules would apply to all securitization transactions, except as otherwise provided, upon effectiveness. Under Section 941(b) of the Dodd-Frank Act, the risk retention rules will become effective one year after the date on which the final rules are published in the Federal Register, with respect to securitizers and originators of asset-backed securities backed by residential mortgage loans, and two years after the date of such publication, with respect to securitizers and originators of all other classes of asset-backed securities.

We believe that it is appropriate to exempt from the risk retention rules securitizations of assets that were originated or issued prior to the date on which the final rules are published in the Federal Register. We refer to such assets as "legacy assets."

As explained by the Agencies in the Proposing Release, the purpose of the risk retention rules is to align the interests of parties to a securitization transaction with those of investors. "[W]hen incentives are not properly aligned and there is a lack of discipline in the origination process, securitization can result in harm to investors, consumers, financial institutions, and the financial system."[117] However, "'When securitizers retain a material amount of risk, they have 'skin in the game,' aligning their economic interest with those of investors in asset-backed securities.' By requiring that the securitizer retain a portion of the credit risk of the assets being securitized, section 15G provides securitizers an incentive to monitor and ensure the quality of the assets underlying a securitization transaction, and thereby helps align the interests of the securitizer with the interests of investors." The Agencies note that "in circumstances where the assets collateralizing the ABS meet underwriting and other standards that should ensure the assets pose low credit risk, the statute provides or permits an exemption."[118]

In the case of loans or other assets that are originated prior to adoption and publication of the final risk retention rules, or asset-backed securities that are issued prior to such time, it will of course not have been possible to create those assets in compliance with a regulatory scheme whose precise terms are unknown. Further, it will in most cases not be possible to retroactively comply with the risk retention regime with respect to legacy assets. In the case of consumer and commercial loans and other receivables, the extension of credit will of course already have been made, and obtaining borrower consent to modifications may not be feasible. In the case of asset-backed securities, their terms generally cannot be materially changed after issuance without affecting the interests of third-party investors, nor in many cases will it be feasible for a sponsor

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[117] Proposing Release, 76 Fed. Reg. 24090 at 24095.
[118] Proposing Release, 76 Fed. Reg. 24090 at 24096.

to repurchase the requisite portions of the applicable ABS interests. Mandated risk retention in securitizations of legacy assets, therefore, will not further the purposes of Section 941(b) of the Dodd-Frank Act by influencing the credit quality of the legacy assets.

We do not believe that this exemption would be broad in scope, or that it would enable sponsors to avoid the risk retention requirements. It is highly unlikely that originators will extend credit more than one or two years prior to the applicable effective date of the risk retention rules solely for the purpose of warehousing the assets for later securitization without the burden of risk retention, or that sponsors will acquire and hold legacy assets for this purpose. Such activity would be uneconomical. We believe that the accommodation that we request here is narrow and reasonable, and is intended only to ask that the Agencies draw a bright line, at a practical point in time, between assets that are subject to the new rules and those that are not.

XIV. Cross-Border Issues

We have been advised that the Association for Financial Markets in Europe / European Securitisation Forum ("AFME/ESF") plans to submit a letter outlining significant issues that would arise for cross-border offerings under the proposed risk retention rules. In particular, we expect that the AFME/ESF letter will call attention to the conflicts between the existing EU risk retention regime and the proposed rules and recommends coordination among regulatory authorities. We urge the Agencies to carefully consider the issues raised by AFME/ESF.

XV. Transactions that Are Not "Securitization Transactions" Involving the Issuance of "Asset-Backed Securities"

A. Recourse Obligations Secured by a Pledge of Financial Assets

Due to the breadth of the new definition of "asset-backed security" added to the Exchange Act by the Dodd-Frank Act, in practice it will be impossible in some cases for market participants to draw a clear dividing line between asset-backed securities subject to the risk retention rule, on one hand, and (on the other hand) securities issuances that may be collateralized by self-liquidating assets but do not function as securitizations or raise the issues that the risk retention requirements are intended to address. We ask the Agencies to provide a safe harbor or other clarification in the final rules for secured transactions such as covered bonds that are essentially corporate-credit-based, secured transactions rather than securitizations.

Businesses often issue securities that are full-recourse corporate obligations (directly or through a guarantee) of a creditworthy entity that is not a special-purpose entity, or SPE, but are also supported by a pledge of financial assets to secure the issuer's repayment obligation. The

credit analysis in such cases takes into account both the characteristics of the assets pledged as collateral and the financial and operational strength of the issuer or guarantor whose corporate credit stands behind the securities. For example, for various reasons, such an issuance may be structured as an issuance of securities by an SPE that in effect acts as a finance subsidiary, pledging collateral to support its repayment obligation, plus a guarantee of those obligations from its corporate parent that is the true credit for the issuance.

In such a case, it is unclear how an issuer is to determine whether payments on the security "depend primarily" on the guarantor's corporate credit or on cash flow from the pledged collateral. Particularly in view of the proposed definition of "collateral," which includes assets that provide cash flow, including "from the foreclosure or sale of the assets or property," for the ABS interests, on its face it would appear that any security that is fully collateralized by any self-liquidating financial assets could be subject to risk retention. This would appear to include, for example, covered bonds and other types of secured issuances that are not recognized by the market as being securitizations and that do not present the hazards that the risk retention rule was intended to guard against.

In a securitization, the risk that the pledged assets fail to pay in accordance with their terms, or may decrease in market value – what the Proposing Release defines as "credit risk"– is borne by investors and not by the entity that arranges for those assets to be pledged. It is this characteristic of securitizations that creates the moral hazard that the risk retention rule is intended to address. In a collateralized full-recourse security issuance (as distinct from a securitization), the issuer or guarantor has no incentive to select collateral that will perform poorly, because doing so does not relieve it of the obligation to make full payment on the security from its own resources. To put it differently, there is no need to require risk retention because the credit risk of the assets has not been transferred to investors in the first place; it remains with the issuer and any guarantor of the securities.

In order to provide guidance to market participants who need to determine whether the risk retention requirement applies to a particular issuance, we request that the Agencies provide a bright-line "safe harbor" that defines conditions under which risk retention is not required even if a security is collateralized by self-liquidating assets. Specifically, we suggest that the Agencies clarify that any security that is (directly or through a guarantee) a full-recourse, general obligation of an entity that (a) is not a special-purpose entity and (b) at the time of issuance has outstanding debt securities that meet the standards recently proposed by the SEC to replace references to credit ratings in the transaction requirements for registration of primary offerings of non-convertible investment grade securities on Form S-3[119] should not be considered to receive

[119] *See* Security Ratings, Securities Act Release No. 33-9186, 76 Fed. Reg. 8946 (Feb. 16, 2011).

payments that depend primarily on cash flow from any assets pledged to support its repayment, and therefore should not be considered an "asset-backed security" as defined in Section 3(a)(77) of the Exchange Act, whether or not that security is issued by an entity that is a special-purpose entity or is secured by self-liquidating financial assets.

B. Insurance-Linked Securities

Another class of securities that, although collateralized by assets, do not function as securitizations or raise the issues that the risk retention requirements are intended to address is insurance-linked securities ("ILS"). ILS transactions are designed to transfer insurance risk to the capital markets. ILS transactions have been limited to private exempt offerings sold only to sophisticated institutional investors. Sponsors of ILS are typically insurance or reinsurance companies, government sponsored insurance entities or industrial companies (each a "Risk Transferring Party"), that are exposed in the ordinary course of their business to losses from natural catastrophes and other loss events or to mortality, policy lapse, health and other insurance risks and investment risk. As part of their management of these risks, Risk Transferring Parties have transferred portions of these risks (typically having low probabilities of occurrence) to the capital markets through ILS transactions in lieu of or as a complement to entering into (re)insurance arrangements in traditional (re)insurance markets. For sophisticated capital markets investors, ILS transactions provide an opportunity to earn a rate of return for exposure to insurance risks that are not correlated to other, traditional investment risks, such as interest rate, credit or market index volatility.

In a typical ILS transaction, an SPE is created to enter into a risk transfer contract with the Risk Transferring Party. The risk transfer contract can take the form of a reinsurance agreement or a contract on an ISDA model form. Under the risk transfer contract, the Risk Transferring party pays a premium to the SPE in exchange for potential payments triggered by a defined catastrophic event or other defined loss event. The SPE is often licensed and regulated as reinsurer in its domicile jurisdiction. The SPE issues bonds with a fixed maturity date at a variable interest rate. Principal is "at-risk," meaning that if a trigger event (for example, a catastrophic hurricane) occurs under the risk transfer contract then part or all of the principal owed may be reduced. The proceeds of the bonds are used as collateral to secure both the SPE's obligation to make trigger event payments to the Risk Transferring Party and to secure the bonds. The collateral is invested in designated high quality investments (which in some transactions are guaranteed under repurchase agreements or total return swaps). The collateral is the only source for payments by the SPE to the Risk Transferring Party under the risk transfer contract if a trigger event occurs. The amount to be paid by the SPE to the Risk Transferring Party may be based upon actual insured losses or may be computed by reference to published estimates of industry losses, modeled losses or some formula based upon parametric measures (like, for

example, the magnitude and location of an earthquake). If no trigger event occurs then the collateral is used to repay principal on the bonds.

A bond investor's return under these ILS structures is not primarily dependent upon the collateral but rather upon the risk of occurrence of the trigger event and upon the premiums paid by the Risk Transferring Party under the risk transfer contract. Although the collateral, consisting of high quality investments, creates some risk for the bond investor, this risk is shared by the Risk Transferring Party. If the value of the collateral is diminished then the amount of reinsurance coverage for the risk associated with the trigger event is reduced commensurately. This is because the recourse of the Risk Transferring Party against the SPE under the risk transfer contract is limited to the collateral.

ILS do not fit within the definition of an "asset-backed security" under Section 3(a)(77) of the Exchange Act because the holder of the insurance-linked security does not "receive payments that depend primarily on cash flow from the asset," but rather upon the risk transfer contract, the premium payments thereunder and the occurrence or non-occurrence of a trigger event. Moreover, a Risk Transferring Party in an ILS transaction does not fit within the definition of a "securitizer" under Section 15G because no sale or transfer of assets to the issuer is being made.

For all of the foregoing reasons, ILS transactions do not present the issues of alignment of incentives that the risk retention rules were designed to address, and to provide guidance to the ILS market, we believe insurance-linked securities should be exempted from the risk retention rules.

Conclusion

The credit risk retention rules constitute an extremely difficult, complex rulemaking for which the Dodd-Frank Act did not allow sufficient time. Careful, deliberate analysis is needed, and fundamental reconsideration of the initial proposal is required. We urge the Agencies in the strongest possible terms to take the time needed to consider the public comments on the proposal, analyze the potential economic and social impacts of the risk retention rules, reconsider the approach taken to such fundamental concepts as how retained risk exposure will be measured, and, at the appropriate time, publish a new proposal for public review and comment.

In addition, we urge the Agencies to consider carefully how the proposed rules can be revised to avoid unduly harsh impacts on the many types of ABS that exhibited strong performance during the recent financial crisis, while adequately addressing those types of ABS that have been subjects of concern since the onset of the financial crisis.

We greatly appreciate your consideration of the views set forth in this letter, and we would be pleased to have the opportunity to discuss these matters further with you or with any member of the staff of any of the Agencies. We would be very interested in meeting with representatives of any of the Agencies at a time and place convenient for you in order to discuss the issues addressed in this letter. Please feel free to contact the undersigned at 212-313-1359, for Richard Dorfman, or 212-313-1126, for Chris Killian.

Sincerely yours,

Richard A. Dorfman
Managing Director
Head of Securitization

Christopher B. Killian
Vice President, Securitization Group

cc: Mary Miller, Assistant Secretary for Financial Markets, Department of the Treasury
Jeff Foster, Senior Policy Advisor, Department of the Treasury
Beth Mlynarczyk, Policy Advisor, Department of the Treasury