



**Sample Risk Retention Due Diligence Discussion Topics  
for Underwriters, Initial Purchasers and Placement Agents  
in ABS Offerings**

**Version 1  
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## **INTRODUCTION AND PURPOSE**

This document was developed by a SIFMA<sup>1</sup> dealer working group on Regulation RR, 17 C.F.R. §246.1, et seq., (the “Credit Risk Retention Rules” or “the Rules”), implementing the credit risk retention requirement of Section 15G of the Securities Exchange Act of 1934. It sets forth potential topics to consider in performing due diligence during the ABS transaction process. It is intended to help guide dealers acting as underwriters, initial purchasers, and placement agents in their efforts to undertake a reasonable investigation to determine if there are any material misrepresentations or omissions contained in a registration statement, prospectus or offering memorandum. Additionally, some suggested pre-marketing discussion topics are presented at the end of the document.

These are potential topics of focus that dealers may wish to consider. The actual topics of focus in any transaction should be narrowed or expanded based on the circumstances and the asset class. This document is not intended to be prescriptive, nor is it intended to apply to every transaction. For example, a periodic (e.g., annual) discussion of some of these topics with a sponsor may be appropriate.

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## **RISK RETENTION DISCUSSION TOPICS**

### **General**

Please describe how the Sponsor intends to comply with the Credit Risk Retention Rules, including the proposed method of holding the required economic interest (the “Retained Interest”) in the credit risk.

- Please describe the reasoning behind the identification of the Sponsor as meeting the definition of “sponsor” for purposes of the Credit Risk Retention Rules.
- Which legal entity will retain the Retained Interest? If a majority-owned affiliate (“MOA”) as permitted by the Credit Risk Retention Rules, please describe the capital structure of such entity, the consolidated accounting treatment of the MOA and the Sponsor and why the MOA complies with the requirements of the MOA definition under the Credit Risk Retention Rules.

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<sup>1</sup> SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over \$2.5 trillion for businesses and municipalities in the U.S., serving clients with over \$20 trillion in assets and managing more than \$67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. 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, visit <http://www.sifma.org>.

- Please confirm that the retaining entity will hold the Retained Interest for the length of time required by the Credit Risk Retention Rules.
- Does the Sponsor or any of its affiliates plan to hedge or finance the Retained Interest in any way? If so, please describe why that hedging or financing does not violate the prohibitions of the Credit Risk Retention Rules.

## **EHRI**

If an “eligible horizontal residual interest” (an “EHRI”) will be used, please describe how the Sponsor arrived at the valuation methodology, inputs and assumptions used for determining the fair value of the issued ABS interests (“Issued ABS Interests”), including the Retained Interest, under U.S. generally accepted accounting principles (“GAAP”).

- Please identify which valuation techniques the Sponsor has employed. Has the Sponsor employed the market approach, cost approach, income approach or combination of any of the foregoing approaches in calculating the fair value of the Issued ABS Interests and Retained Interest?
- Has the Sponsor or its affiliates recently purchased or sold a residual in an asset-backed issuer comparable to the Retained Interest? If so, please provide details about the determination of market and the price. Is the fair value of the EHRI in this transaction being calculated in a similar manner, and if not, why?
- What are the inputs and assumptions (each, an “Input”) that the Sponsor employed in order to measure the fair value of the Issued ABS Interests and Retained Interest? Please identify whether each of these Inputs was a Level 1, Level 2 or Level 3 input under GAAP. What reference data set or other historical information was used to develop each of the Inputs?
- What information is the Sponsor using for each of the Inputs?
  - If using prepayment assumption as an Input:
    - What does the Sponsor consider to be “prepayment” for purposes of this assumption? Does the Sponsor include both voluntary and involuntary prepayments?
    - Is there any difference between prepayment speed used for fair value calculation and prepayment speed used for pricing? If so, why?
  - If using loss assumption as an Input: *[Note: The Credit Risk Retention Rules also contemplate “default rates,” “loss given default (recovery)” and “lag time between default and recovery.” The topics below may be considered for each of these.]*
    - Is the Sponsor utilizing historical loss information? If so, how many years of historical loss is the Sponsor taking into account?

- Is the Sponsor utilizing internal loss projections? If so, what information, factors, circumstances, and events are such projections based on and what would cause such projections to change?
  - Is the Sponsor utilizing rating agency projections? If so, have the rating agency projections been stressed?
  - Does the loss assumption take into account any recent negative trends?
  - If a discounted cash flow model is used, are losses assumed to be recognized under a loss curve or a straight line basis? Is that consistent with the performance of the Sponsor's past transactions?
  - For loss given default, what assumptions is the Sponsor making about the future value of any collateral securing the assets?
- What interest rates were assumed on the bonds in determining the discounted cash flows?
- If using discount rate assumption as an Input:
  - How was the discount rate determined?
  - Does the discount rate take into account any recent increases in interest rates or spreads?
  - Is the Sponsor utilizing a return on equity number ("ROE")? If so, what assets account for the Sponsor's equity and how does the ROE correlate to the principal market for the Retained Interest?
  - Is the Sponsor utilizing another model (e.g. capital asset pricing model or CAPM)? If so, how does such model correlate to the principal market for the Retained Interest?
- If a floating rate transaction, how did the Sponsor determine the basis of forward interest rates used?
- For timing of the last principal payment, is the Sponsor making the assumption that a clean-up call will be exercised?
- If the transaction is revolving, what assumptions did the Sponsor make about future assets to be added to the transaction?
- Is the Sponsor prioritizing observable over non-observable Inputs when determining the fair value of the Retained Interest?
- Is the Sponsor determining that each of the Inputs reflect assumptions that market participants would use in pricing the Retained Interest? What steps is the Sponsor taking to ensure that each Input calibrates to fair value or market terms?
- Other than the transaction parties, will the Sponsor utilize any third party to provide any information or data used for the Inputs?
- How does the Sponsor propose to make any disclosure required by Section 4(c)(2)(ii) of the Credit Risk Retention Rules?

## **Verification & Controls**

Describe verification and control procedures the Sponsor employs to confirm its fair value measurement methodology meets GAAP and appropriate regulatory standards, including the Credit Risk Retention Rules.

- Do the Sponsor’s Legal and/or Compliance agree that the Retained Interest complies with the Credit Risk Retention Rules?
  
- What policies does the Sponsor have in place for ensuring that (i) the retaining entity will not transfer the Retained Interest in contravention of the Credit Risk Retention Rules and (ii) the Sponsor and its affiliates will not engage in any hedging or financing transactions with respect to the Retained Interest that are prohibited by the Credit Risk Retention Rules?
  
- If an EHRI will be retained:
  - Please describe the verification and control procedures the Sponsor employs to confirm its fair value measurement methodology meets GAAP and appropriate regulatory standards, including the Credit Risk Retention Rules.
  - Will the valuation methodology and results utilized for the Retained Interest be validated by the Sponsor’s internal and/or external accountants?

## **Pre-Marketing Bring-Down Discussion Topics**

- Please confirm that the Sponsor has not changed [(since the most recent full diligence session)] how it intends to comply with the Credit Risk Retention Rules, including the identification of the Sponsor as the “sponsor” for purposes of the Credit Risk Retention Rules, the method of holding the required credit risk, the legal entity that will retain the Retained Interest and (if a majority-owned affiliate of the Sponsor) its capital structure, and any plans to hedge or finance the Retained Interest.
  
- If an EHRI will be retained, please confirm that the Sponsor has not changed [(since the most recent full diligence session)] its approach to valuation, including the method by which it arrived at the methodology, the inputs and assumptions used, the valuation techniques and Inputs employed, whether the Sponsor ever sold a comparable residual, any prioritization of observable Inputs, any determination that each Input reflects assumptions that market participants would use in pricing the Retained Interest, any steps taken to ensure that each Input calibrates to fair value or market terms, and the use of any third party to provide any Input data.
  
- Please confirm that the Sponsor has not changed [(since the most recent full diligence session)] its controls regarding the Retained Interest, including any policies regarding

transfer or hedging of the Retained Interest, and (if an EHRI will be retained) verification and control procedures for its valuation and any validation of the valuation by the Sponsor's accountants and confirmation of compliance by its legal and/or compliance functions.