November 12, 2010

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The Honorable Ben S. Bernanke
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The Honorable Shaun L. S. Donovan
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Re: Implementing Section 941 (Regulation of Credit Risk Retention) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 for RMBS

Ladies and Gentlemen:

The American Securitization Forum ("ASF")[1] submits this letter to express our views relating to implementation of Section 941 (Regulation of Credit Risk Retention) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act") for residential mortgage-backed

[1] The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory and market practice issues. ASF members include over 330 firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. ASF also provides information, education and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. For more information about ASF, its members and activities, please go to www.americansecuritization.com.

securities ("RMBS"). ASF supports reforms within the securitization market and we commend the regulatory agencies for seeking industry input prior to proposing rules on this critically important issue. Over the past decade, ASF has become the preeminent forum for securitization market participants to express their views and ideas. ASF was founded as a means to provide industry consensus on market and regulatory issues, and we have established an extensive track record of providing meaningful comment to various regulators on issues affecting our market. Our views as expressed in this letter are based on feedback received from our broad membership, including our issuer and institutional investor members.

We support efforts to align the incentives of issuers and originators with securitization investors and believe these incentives should encourage the application of sound underwriting standards by both the originator and securitizer in connection with the assets that are securitized. We believe that risk retention can aid in achieving this goal so long as the requirements are tailored appropriately to each class of securitized assets. This letter will address ASF's views concerning the implementation of Section 941 of the Act as it relates to RMBS. We intend to submit additional letters in short order that will address our membership's views relating to asset-backed commercial paper as well as asset-backed securities backed by other assets, including credit card receivables, student loans and automobile loans.

Section 941(b) of the Act requires the Federal Deposit Insurance Corporation ("FDIC"), the Federal Reserve Board of Governors ("FRB"), the Office of the Comptroller of the Currency ("OCC"), the Securities and Exchange Commission (the "Commission"), the Secretary of Housing and Urban Development ("HUD"), and the Federal Housing Finance Agency ("FHFA" and collectively, the "Joint Regulators") to jointly implement rules to require any "securitizer"[2] to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an "asset-backed security,"[3] transfers, sells, or conveys to a third party. Section 941(c) of the Act sets forth the general standards for retention by requiring a securitizer to retain "(i) not less than 5 percent of the credit risk for any asset" or "(ii) less than 5 percent of the credit risk for an asset…if the originator of the asset meets the underwriting standards prescribed under paragraph (2)(B)." The regulations prescribed under Section 941(b) must specify "the permissible forms of risk retention" and "the minimum duration of the risk retention." In addition, the regulations "shall establish asset classes with separate rules for securitizers of different classes of assets, including residential mortgages, commercial mortgages, commercial loans, auto loans, and any other class of assets that the Federal banking agencies and the Commission deem appropriate." Section 941(c) of the Act further provides that if an asset-backed security is secured entirely by "qualified residential mortgages," the risk retention requirements shall not apply. The definition of "qualified residential mortgage" is to be established by the Joint Regulators in accordance with certain criteria set forth in the Act.

As noted above, we firmly believe that risk retention requirements should be appropriately tailored for each major class of asset-backed securities. Different types of loans and securitized

[2] We note that Section 941(a) amends the Securities Exchange Act of 1934 (the "Exchange Act") to include a definition for the term "securitizer" which is, generally, an issuer of Exchange Act ABS or a person who organizes and initiates an Exchange Act ABS transaction by transferring assets to the issuer.

[3] We note that Section 941(a) amends the Exchange Act to establish an alternative definition of "asset-backed security" that is broader than the existing definition set forth in Regulation AB.

assets present wide variations in expected credit and performance characteristics. Given this variability, any blanket, one-size-fits-all retention requirement would be arbitrary in its application to any particular asset type, and would not reflect important differences in the expected credit and performance characteristics of each asset as well as the related securitization structures. The Board of Governors of the Federal Reserve System, in its recently published Report to the Congress on Risk Retention (the "Federal Reserve Study"), concurred in this assessment, stating:

> Thus, this study concludes that 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 … Given the degree of heterogeneity in all aspects of securitization, 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 … In light of the heterogeneity of asset classes and securitization structures, practices and performance, the Board recommends that rulemakers consider crafting credit risk retention requirements that are tailored to each major class of securitized assets.[4]

ASF supports the intent of Section 941 of the Act to encourage sound underwriting decisions by improving the alignment of interests between sponsors of securitizations and originators of loans on the one hand and investors in asset-backed securities on the other. However, in order to avoid jeopardizing the fragile recovery of the RMBS market and promote the flow of affordable credit to prospective homeowners provided by that market, it is essential that an appropriate exemption is made to the risk retention requirements and that suitable options are available to comply with such requirements. We respectfully submit herein our views concerning the appropriate criteria for a "qualified residential mortgage" and the types of mechanisms that should be available within RMBS securitizations to comply with the risk retention requirements.

[4] The Board of Governors of the Federal Reserve System, Report to the Congress on Risk Retention, available at http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf, p. 3, 83-84.

I. The Qualified Residential Mortgage Exemption

Congress provided for an exemption from the risk retention requirements for asset-backed securities collateralized entirely by "qualified residential mortgages" (each, a "QRM") in Section 941 of the Act. The Joint Regulators are required to promulgate a definition of QRM that takes into consideration "underwriting and product features that historical loan performance data indicate result in a lower risk of default." The Act further provides that such definition shall be no broader than the definition of "qualified mortgage" as defined under Section 1412 of the Act (and regulations adopted thereunder).[5] After extensive discussion with our issuer and investor members, we have formulated detailed criteria that we hope will guide the Joint Regulators in their efforts to establish the QRM definition (the "Proposed QRM Criteria," which are attached hereto as Exhibit A) and we have set forth below our rationale with respect to the criteria as a whole as well as certain key aspects.

We applaud Congress' efforts to promote high quality underwriting by providing for an exemption from the risk retention requirements for mortgage loans that meet specified minimum criteria. We agree with John C. Dugan, former Comptroller of the Currency, that the establishment of such minimum standards is the most direct way to align incentives within the RMBS market.[6] Mr. Dugan has suggested that minimum standards for loan origination "stick to the basic, core standards on which there is clearest consensus" and should include "effective verification of income and financial information, meaningful down payments, reasonable debt-to-income ratios and for monthly payments that increase over time, qualifying borrowers based on the higher, later rate, rather than the lower, initial rate."[7] We believe our Proposed QRM Criteria address each of these critically important components.

The Proposed QRM Criteria represent a consensus view as to the appropriate framework for the Joint Regulators to consider in proposing rules for a QRM. Issuers and investors have agreed upon mortgage loan characteristics and borrower metrics that have traditionally evidenced a lower risk of default and we have set forth below a description of each of those criteria. However, as described in further detail below, issuers and investors did not agree on all of the quantitative and qualitative details within the proposed framework, including the appropriate number of months of verification required for income, the amount necessary for a meaningful down payment and the suitable level of borrower debt as compared to monthly income. While we are hopeful that with additional time these two groups would potentially reach a near consensus position, we believe that the agreed-upon framework set forth in this letter provides regulators with a valuable tool to begin the QRM debate. Finally, we are available to discuss the Proposed QRM Criteria with the Joint Regulators at any time and able to provide historical loan performance data to aid the discussion.

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[5] It is important to note, however, that the Board of Governors of the Federal Reserve System is authorized under Section 1412 of the Act to prescribe regulations that modify the definition of "qualified mortgage" if such regulations are "necessary and proper to ensure that responsible, affordable mortgage credit remains available to consumers in a manner consistent with the purposes of this section." Therefore, to the extent the regulators believe that our proposal would go beyond the "qualified mortgage" definition set forth in the Act, we urge that they utilize their authority to expand that definition.

[6] Remarks by John C. Dugan, former Comptroller of the Currency, before the American Securitization Forum (February 2, 2010).

[7] *Id*.

Timing of QRM Determination

The determination of whether a loan is a QRM should be made at the time the loan is originated, unless the loan is modified prior to its inclusion in a securitization. It is essential for the proper functioning of the residential mortgage market that originators are able to determine the securitization options available for a loan at the time the loan is originated. The anticipated economic terms of the securitization, which include whether risk retention will be required, will substantially influence the terms of the loan, including the interest rate charged to the borrower. It is also important that the determination of whether a loan is or is not a QRM not be changed after the closing of the securitization (even if the loan is modified), because it would not be feasible to require a sponsor to assume risk with respect to a securitization after the transaction had closed and the securities were issued. We note that under our Proposed QRM Criteria, it is highly unlikely that modifications to mortgage loans after origination would change their QRM status, because the criteria focus primarily on underwriting standards.

Verification of Income, Assets and Employment

Appropriate verification of income should be a key factor in determining that a loan is a QRM. Our issuer members propose that borrowers be required to verify 12 months of income, provided that for employees who are new to the workforce or who have returned to the workforce within the prior 12 months, income verification should only be required for the period of time during the prior 12 months in which the borrower was employed. Our investor members agree with this general standard, but believe that 24 months of income verification should be provided.

It is also important that the definition permit flexibility in how income is verified in order to permit borrowers with a variety of different employment situations to prove their incomes. In addition, it is appropriate that the QRM definition make an allowance for borrowers who receive income from assets they own, as opposed to solely from wages they receive, to avoid inadvertently excluding loans made to retirees and certain high net worth individuals who may not collect wage income. Therefore, the definition should allow income to be imputed based on a conservative estimate of the amount the borrower will receive from assets he or she owns, provided that the loan originator verifies the value of such assets and that they are in fact owned by the borrower. Our issuer members believe that imputing income is critical so that a large number of highly creditworthy borrowers are not excluded from the QRM definition. If imputing income is not permitted, entire classes of borrowers (including retired persons and others whose income is not composed primarily of wages) may incur higher costs to secure mortgage credit, even though loans to such borrowers do not represent greater credit risk.

The Proposed QRM Criteria also set forth appropriate asset and employment verification procedures.

Down Payment Requirements

The Act does not expressly include down payment requirements as a factor that the Joint Regulators should consider in formulating the QRM definition. Nevertheless, we believe it is critically important that borrowers have an adequate equity interest in the property secured by the mortgage. Recent history has demonstrated that borrowers who do not have a significant equity

interest are substantially more likely to default in payment of their loans and surrender their properties to foreclosure. Therefore, we propose that in order for the loan to be a QRM, the borrower must make a significant down payment. This requirement will provide substantial additional protection to investors for loans with higher loan-to-value ratios.

Our issuer members believe that the down payment should be no less than 5% of the purchase price, and that such payment must come from the borrower's own funds. They note that this requirement would satisfy the current standards of Fannie Mae and Freddie Mac. In addition, our issuer members propose requiring primary mortgage insurance for any QRM that has a loan-to-value ratio of greater than 80%. Our investor members propose that the down payment should be no less than 20% of the purchase price (not including any borrowed funds to the extent repayment of such funds is secured by a second lien on the mortgaged property). Our issuer members are concerned that requiring such a high down payment may lead to a significant increase in the number of loans that are insured by the Federal Housing Administration, since such loans are exempt from the risk retention requirements and require substantially lower down payments. Issuers believe as a matter of public policy that it would be undesirable to create or perpetuate a non-level playing field as between government insured and privately issued mortgage products in which underwriting standards for government insured loans are substantially lower in any important respect, except where demonstrably necessary to advance an established public policy such as affordable housing.

Debt-to-Income Ratios

The Proposed QRM Criteria set forth required percentages for both "front-end" and "back-end" debt-to-income ratios. This is consistent with the Act's suggestion that in defining QRM the Joint Regulators consider the ratio of total monthly installment payments to income. However, in circumstances where certain specific, objective and quantifiable compensating factors exist, we believe exceptions to the "back-end" debt-to-income requirements are warranted. For example, if a borrower owns significant unencumbered assets (such as investment accounts) and the existence and value of those assets can be verified, the required "back-end" debt-to-income ratio should be adjusted accordingly in order to avoid creating an incentive for borrowers to liquidate such assets. We are currently working with issuers and investors to prepare a specific list of compensating factors that are both objective and quantifiable, which we hope to submit to the Joint Regulators. We propose that the compensating factors that are ultimately approved by the Joint Regulators be included in the QRM definition and exceptions to the debt-to-income ratio requirements only be permitted if one or more particular compensating factors are present. Our investor members stress the importance of these compensating factors being truly objective and quantifiable so that the standards do not erode over time. Our issuer members stress that if such exceptions are not permitted, many loans that have a low likelihood of defaulting would be excluded from the definition. This would unjustifiably increase the cost of borrowing for certain consumers whose loans constitute a relatively low credit risk.

Adjustable Rate Loans and Mitigating the Potential for Payment Shock

The Act encourages the Joint Regulators to consider mitigating the potential for payment shock on adjustable rate mortgages when formulating the QRM definition. Therefore, we suggest that

short term adjustable rate loans with a fixed rate term of less than three years be excluded from the QRM definition. Adjustable rate loans with a fixed rate term of five years or more should be permitted to qualify as QRMs, provided that the borrower demonstrates an ability to repay the loan at the greater of the fully indexed rate or the note rate. Adjustable rate loans with a fixed rate term of three years should also be permitted to qualify as QRMs, provided that the borrower meets the higher threshold of demonstrating an ability to repay the loan at the greater of the fully indexed rate or the note rate, plus 2%. In addition, in order to fit within the QRM definition, all adjustable rate loans will be required to include first adjustment date, subsequent adjustment date and lifetime rate caps as set forth in the Proposed QRM Criteria. We believe that by requiring adjustable rate borrowers to show that they can repay their loans even when the rates increase and by capping potential rate increases at specified maximums, the potential for payment shock and subsequent default is substantially mitigated.

Interest Only Loans

Our issuer members believe that interest only loans should be able to qualify as QRMs provided that they meet certain criteria. However, our investor members believe that these loans should be excluded from any QRM framework given their recent poor performance. Under our issuer members' proposed requirements, a qualifying interest only loan should be required to convert to a fully amortizing payment schedule after a specified period of time has elapsed. The borrower should be required to demonstrate the ability to make the monthly payments that will be required once the loan becomes fully amortizing, not just the initial interest only payments. In the case of adjustable rate interest only loans, the borrower should also be required to demonstrate the ability to make payments at the fully indexed rate. In addition, qualifying interest only loans should not provide any option for the borrower to defer payments or alter the amortization schedule.[8]

While we understand that interest only loans have historically had high default rates, our issuer members believe that if originated in accordance with the more stringent criteria proposed here, these loans will have no greater prospect of default than any other loan product. Interest only loans are a valuable financing tool for certain types of mortgage loan borrowers, particularly prime borrowers with substantial equity in the underlying properties who wish to take advantage of the tax benefits associated with mortgage interest payments. These types of borrowers generally represent a very low default risk and therefore loans made to them should be permitted to qualify as QRMs. Our issuer members would welcome an opportunity to meet with the appropriate regulatory agencies to discuss their rationale for the inclusion of interest only loans that meet the described criteria in the QRM definition and to provide data that supports their position that such loans do not have an unreasonably high potential to default. Even if it is determined that interest only loans must be completely excluded from the QRM definition at this

[8] We believe that this requirement will cause interest only loans to fit within the "qualified mortgage" definition promulgated under Section 1412 of the Act, because the loan will not "allow the consumer to defer repayment of principal." However, as discussed in footnote 5 above, the regulators have the authority to modify such definition if appropriate.

time, we ask that the Joint Regulators consider permitting such loans to be added in the future as additional historical data supporting their inclusion becomes available.[9]

Streamlined Refinancings

The Proposed QRM Criteria set forth different requirements for income and asset verification and property valuation for loans that qualify as "streamlined refinancings," which are generally loans made by a lender to refinance a loan that such lender either originated or is currently servicing. The main purpose of underwriting standards is to attempt to ensure that the loan being made will be repaid in a timely manner. In the case of streamlined refinancings, the borrower has already demonstrated his or her ability to repay the loan, and therefore it is not generally necessary for a lender to require the same level of evidence of such ability as would be required in a new origination. In addition, the lender on a streamlined refinancing has a level of familiarity with the property securing the loan and with the borrower that makes compliance with the same formalistic criteria unnecessarily burdensome. Public policy considerations also support allowing streamlined refinancings, because they permit borrowers to refinance from interest only or adjustable-rate mortgage loans into more stable and sustainable loan products.

Loans made in accordance with Government Modification and Refinancing Programs

The United States government has recently sponsored a number of programs designed to assist homeowners by encouraging mortgage loan refinancings and promoting modifications in lieu of foreclosures. Such programs include the Home Affordable Modification Program and the Home Affordable Refinance Program. Our issuer members believe that mortgage loans refinanced or modified pursuant to the terms of such government programs should qualify as QRMs. This will provide an incentive to lenders to participate in such programs, while excluding such loans could jeopardize the success of such programs because loan originators will be less likely to participate in them. However, our investor members do not believe that the inclusion of such loans within the QRM definition is appropriate because they have historically had high re-default rates and are generally not required to meet important quality metrics such as "back-end" debt-to-income ratio requirements.

Excluded Loan Types

We believe that certain loan types should be excluded entirely from the QRM definition in light of the historically poor performance of such loans. These include loans that provide for "balloon" payments of principal at the end of their terms, loans with negative amortization features, loans that assess penalties in the event of prepayment, payment option adjustable rate loans, adjustable rate loans with fixed rate terms of less than three years and loans considered to be "high cost" under applicable federal guidelines.

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[9] As a general matter, we believe it is important that the Joint Regulators remain willing to amend the QRM definition and the other risk retention rules in the future as the ABS market continues to develop. We note that this is consistent with the recommendations of the Federal Reserve Study, which encourages the Joint Regulators to consider that "credit risk retention requirements that are appropriate in light of current market practices may, if not modified over time, fail to achieve their objectives or have unintended consequences." *See* Federal Reserve Study, p. 85.

Use of Historical Data

Our issuer members stress that their determination regarding what loan features should be permitted as part of the QRM definition is based on historical data indicating that loans with these features have a relatively low risk of default. Issuers firmly believe that the Joint Regulators should give a great deal of consideration to such historical data in implementing the QRM definition, as it is the best indicator of how particular loan types can be expected to perform in the future.

Issuers and investors agree that the Joint Regulators should periodically reconsider the QRM definition to evaluate whether it continues to reflect appropriate criteria for loans not subject to risk retention requirements and they would welcome the opportunity to meet with the Joint Regulators to share data and discuss their views.

II. Reductions in Risk Retention Requirements

We note that the Act requires all loans underlying an RMBS transaction to be QRMs in order for the transaction to have the benefit of the QRM exemption from the risk retention requirements. Our issuer members do not believe it is appropriate or logical for a transaction to be subject to the full risk retention requirements simply because one of the loans included in such transaction does not meet the Proposed QRM Criteria. Therefore, issuers urge the Joint Regulators to utilize their discretionary authority under the Act to provide for a lower risk retention requirement for RMBS transactions secured primarily, but not entirely, by QRMs.

In addition, our issuer members are concerned that many loans made to high quality, low risk borrowers may fail to meet the QRM definition because they do not meet one (or a small number) of specific criteria, even though significant compensating factors may be present. Therefore, issuers also request that the Joint Regulators establish a lower risk retention threshold for transactions that include a specified percentage of loans that do not meet the QRM definition, provided that such loans meet the bulk of the QRM criteria and other factors are present that compensate for the criteria that are not met.

III. Forms of Risk Retention

Our issuer members strongly believe that a range of risk retention options should be available for RMBS and that a sponsor or an affiliate of the sponsor should be able to satisfy the risk retention requirement through any one, or a combination, of these options. The options available to an issuer should include vertical slice risk retention, horizontal slice risk retention, retention of representative samples or retention of a contractual exposure. In the Federal Reserve Study, the FRB encourages the Joint Regulators to consider that investors may demand additional or other forms of credit risk retention to address "idiosyncratic features of assets or characteristics of securitization chain participants,"[10] even among assets of the same class. Therefore, issuers believe that a range of alternatives would be desirable, in order to allow sponsors to retain credit risk in a manner that is consistent with investor demands. However, as set forth below, our investor members have concerns with some of the proposed alternatives.

[10] Federal Reserve Study, p. 85.

A range of options is also necessary because relevant accounting consolidation standards have moved from being risk-based to being control-based and, as a result, a sponsor's retention of even a modest amount of risk in a securitization can now result in all of the securitized assets being consolidated onto the sponsor's balance sheet. As a general matter, consolidation of a securitization vehicle is required when a reporting entity maintains a controlling financial interest in the securitization issuer. A controlling financial interest will be deemed to exist if such reporting entity (i) has the power to direct the activities of the issuer that most significantly impact the issuer's economic performance and (ii) has the obligation to absorb losses that could potentially be significant to the securitization vehicle or the right to receive benefits that could potentially be significant to the securitization vehicle.[11] A reporting entity that is required to consolidate the assets of a securitization issuer is considered to be the "primary beneficiary" of the securitization.[12] In RMBS transactions, the servicer of the underlying mortgage loans will generally be the entity that has the power to direct the activities of the issuer that most significantly impact its economic performance. This is because the servicer controls decisions relating to the modification of and foreclosure on troubled loans and generally cannot be removed except for cause.[13] Alternatively, in certain transactions some may take the view that the entity with the power to direct the activities of the issuer could be either: (1) an entity (such as a sponsor that retains ownership of the servicing rights) that has the ability to terminate the servicer without cause and appoint a new servicer, or (2) an entity (such as the majority holder of a "controlling class") that has the ability to direct major servicing decisions.

We agree with the Federal Reserve Study urging the Joint Regulators to consider the interaction of credit risk retention requirements with accounting and regulatory capital treatment in light of the fact that such interaction could have "a significant effect on the cost and availability of credit"[14] and highlights the concern that such interplay "may make securitization a less attractive form of financing and may result in lower credit availability."[15]

Consolidation has its own accounting considerations for financial institutions, but given the new risk-based capital rules announced early this year, banks may be deterred from engaging in any meaningful securitization in the future solely based on risk-based capital considerations. For example, some forms of risk retention, such as a horizontal slice, could require a bank sponsor to consolidate 100% of the securitized assets for accounting purposes even though the amount of risk retention is only 5%. The costs associated with such a result would be prohibitively high for banks. Although exposed to only 5% of the risk, the bank sponsor would be forced to hold loan loss allowances against 100% of the securitized assets. In addition, because risk-based capital rules continue to be based on balance-sheet assets despite the shift from a risk-based to a control-based accounting consolidation standard, the bank sponsor also would need to hold risk-based

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[11] Financial Accounting Standards Board Accounting Standards Codification, Topic 810-10-25-38. Note that the views of our accounting committee set forth below assume that the Joint Regulators do not dictate by rule that the required risk retention is "significant" for accounting purposes.
[12] *Id*.
[13] The Federal Reserve Study notes that the "control" aspect of consolidation analysis could result in institutions "selling servicing rights and distancing themselves from their customers" in order to avoid consolidation. *See* Federal Reserve Study, p. 74.
[14] *Id*. p. 84.
[15] *Id*. p. 3.

capital on 100% of the securitized assets rather than on only the 5% that has been retained. Even worse, from a market perspective, investors holding the risk associated with the other 95% of the securitized assets would be holding loan loss allowances and (if any are banks) risk-based capital on their investments as well. The consequence is $1.95 of reserves for every $1 in expected or unexpected losses, misaligned incentives for sponsors and investors, and an unnecessary drain of available credit from the residential-mortgage market.

Further, in the case of an insured depository institution, risk retention that requires accounting consolidation would preclude the sponsor from taking advantage of the FDIC's full Securitization Safe Harbor and would leave available only the new "remedies" Securitization Safe Harbor for on-balance sheet transactions.[16] For securitization transactions covered by the latter, the FDIC has claimed the power to control even securitized assets that have been legally isolated in a separate legal entity and the power to repudiate the securitization agreements and pay damages to investors.[17] This legal outcome, which in the FDIC's view directly results from accounting consolidation, has already created trepidation in the bank-securitization market and, in our view, would severely limit the availability of mortgage credit to consumers.

In our discussion relating to the forms of risk retention, we contemplate risk being retained by the sponsor of a securitization (as such term is used in Regulation AB) or by its affiliate (by which we mean any entity under common control with the sponsor). Retention by the sponsor is clearly contemplated by the definition of "securitizer" in Section 941 of the Act. We believe that also permitting the retention requirement to be met by an affiliate of the sponsor would be appropriate, as it would allow market participants a greater degree of flexibility in structuring their internal allocation of assets and liabilities, while still effectively requiring the risk of loss to be borne by the entity responsible for structuring the securitization transaction.[18]

Each of the forms of risk retention that we propose (other than representative samples) contemplates retention of a portion of the risk on an aggregate basis in the entire pool of mortgage loans that are being securitized, as opposed to retention of a portion of the risk in each individual mortgage loan. We believe that retention on an aggregate basis is appropriate and reflects the intention of Section 941 of the Act.[19]

The forms of risk retention that we propose are set forth below. Our issuer members firmly believe that these different forms of risk retention, utilized individually or in combination, will meet the Act's goal of promoting sound underwriting practices by requiring sponsors (or their

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[16] This is in contrast to the Securitization Safe Harbor for off-balance sheet transactions, under which the FDIC agrees not to reclaim, recover or recharacterize the assets of the securitization.

[17] This "remedies" safe harbor creates additional concerns for investors looking to be made whole on their investment in the event of a securitization sponsor's insolvency. Please see our comment letter submitted to the FDIC in response to their Securitization Safe Harbor NPR issued on May 11, 2010 at http://www.americansecuritization.com/uploadedFiles/ASF-FDIC-NPR-Response-Letter-7.1.10.pdf.

[18] Note that this discussion assumes that all of the risk required to be retained will be held by the sponsor or an affiliate and does not contemplate any reduction in such required retention as a result of risk being retained by an originator.

[19] We note that the Federal Reserve Study, through its discussions regarding horizontal versus vertical risk retention, effectively suggests that retention on an aggregate basis is appropriate. *See, e.g.*, Federal Reserve Study, p. 15 and 72.

affiliates) to retain a portion of the risk inherent in a securitization structure, while at the same time permitting the RMBS market to effectively function. As discussed further below, our investor members have expressed concerns regarding certain of the proposed forms of risk retention and ultimately support only a "horizontal" or "vertical slice" risk retention.

Vertical Slice

Sponsors or affiliates should also be permitted to retain risk by maintaining ownership of a "vertical slice" of the securitization structure. The entity would retain a minimum of a 5% interest (or other required percentage) in each tranche and in any equity interest, net of hedge positions directly related to the securities owned by such sponsor or affiliate. We note that both the Commission, in its proposed rules for asset-backed securities (the "Proposed ABS Rules") and the FDIC, in its rules relating to the securitization safe harbor (the "Securitization Safe Harbor"), have expressed their support for vertical slice risk retention.

This form of risk retention can be distinguished from horizontal risk retention from an accounting consolidation perspective because the interest that is retained is not concentrated in the first loss tranche, but is instead spread equally throughout the capital structure. As a result, our accounting committee, comprised of senior accounting professionals from financial institutions and accounting firms, has advised us that this form of risk retention, in and of itself, would likely not require the sponsor of such transaction to consolidate the assets of the securitization issuer onto its balance sheet (even if the sponsor or an affiliate is acting as servicer), because the retained interest would not constitute an obligation to absorb losses or a right to receive benefits that could potentially be significant to the securitization issuer.[20] This conclusion, however, is dependent upon the sponsor owning no more than 5% of each tranche, including 5% of the equity tranche. A higher percentage of retention could change the analysis and require consolidation. In addition, this analysis assumes that no additional facts or circumstances exist that could lead to the conclusion that the sponsor has a controlling financial interest in the issuer.

In cases where the sponsor and servicer are affiliated, our investor members believe that vertical slice risk retention may better protect their interests when compared to horizontal risk retention, because the servicer would not have an incentive to adopt servicing strategies that benefit one tranche over another. As the Federal Reserve Study notes, while horizontal risk retention may better reduce a sponsor's incentive to securitize loans that are likely to perform poorly, it also may potentially encourage an affiliated servicer to make decisions that favor the retained subordinate tranche over the more senior tranches.[21] This tension demonstrates the importance of permitting multiple forms of risk retention and enabling the market to determine the form of risk retention that is appropriate in a given transaction.

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[20] The Federal Reserve Study concurs in this assessment, noting that vertical slice risk retention is less likely to result in consolidation than horizontal risk retention. *See* Federal Reserve Study, p. 71-72.
[21] Federal Reserve Study, p. 15 and 44.

Horizontal Slice

Sponsors or affiliates should be permitted to retain risk by maintaining ownership of a "horizontal slice" of the securitization structure. This could be accomplished by the sponsor or an affiliate retaining either: (1) an equity interest in the issuing entity, (2) a "first loss" tranche representing overcollateralization and the right to receive excess interest (note that in REMIC transactions, such an interest can be a first loss tranche rather than an equity interest), or (3) a "first loss" tranche with a stated principal amount (as used in transactions that do not have overcollateralization or excess interest features); in either case such that the value of the retained interest[22] represents a minimum of 5% (or other required percentage) of the aggregate principal balance of all assets included in the securitization trust (net of hedge positions directly related to the securities owned by such sponsor or affiliate). If retaining an interest in the first loss tranche or equity component, the sponsor or its affiliate might be required to retain the entirety of such tranche or equity interest or, if the tranche or equity interest has a high enough value relative to the aggregate principal balance of all assets included in the securitization trust, the retention requirements might be met by the sponsor holding only a portion of such tranche or equity interest, in which case the remainder could be sold to a third party.

Our accounting committee has advised us that if the sponsor or an affiliate is also acting as servicer of the transaction (as is commonly the case in RMBS transactions), this form of risk retention would likely require the sponsor of such transaction to consolidate the assets of the securitization issuer onto its balance sheet, because (i) as servicer, the sponsor or its affiliate would have the power to direct the activities of the issuer that most significantly impact its economic performance and (ii) the retained first loss tranche or equity interest would constitute an obligation to absorb losses that could potentially be significant to the issuer. Horizontal slice risk retention would likely not cause consolidation if the servicer of the loans was not an affiliate of the sponsor.

Our investor members harbor concerns about horizontal risk retention because if the servicer and the sponsor are affiliated, the servicer may be motivated to adopt servicing strategies that benefit the first loss tranche or equity interest over the other tranches. This risk is further described in our discussion of vertical slice risk retention, above. Our issuer members note, however, that servicers are generally required to administer the mortgage loans underlying an RMBS transaction in accordance with a contractually established servicing standard. This standard usually requires servicers to act in the best interests of all investors taken as a whole, without regard to any securities that the servicer or an affiliate may own. The servicer is further generally required to administer the loans in the same manner in which it services and administers loans for its own portfolio. Our issuer members believe that the existence of this contractual obligation, combined with other protections generally present in RMBS transactions,

[22] If retention is accomplished through holding a first loss tranche with a stated principal amount and no excess interest component, the value of the retained interest will simply be equal to the principal balance of the portion of the tranche that is retained. If, however, retention is accomplished through holding either an equity interest or a first loss tranche representing overcollateralization and excess interest, then the value of such equity interest or first loss tranche should be calculated using the present value of its projected cash flows based on assumed pool performance characteristics, assuming no credit losses.

substantially mitigates the investors' concern that servicers will act in a manner that further their own interests to the detriment of other investors.

Investors also have concerns about excess cashflow being released too early in the life of a transaction to the first loss tranche or equity component thereby reducing the risk retention. Our issuer members believe that this concern can also be substantially mitigated by various protective mechanisms common in RMBS structures. For example, transactions often have trigger mechanisms that do not permit the release of excess cashflow to subordinate tranches or equity interests until a specified period of time after issuance. In addition, these features may prohibit or limit the cashflow to such classes if significant losses have occurred or significant loan delinquencies exist.

Representative Samples

This form of risk retention would require the sponsor or an affiliate to retain a randomly selected number of loans from a proposed securitization pool such that the aggregate principal balance of the retained loans is at least equal to 5% (or other required percentage) of the aggregate principal balance of all loans in such proposed securitization pool (net of any hedge positions directly related to the loans retained by such sponsor or affiliate). The remaining loans would be transferred to the issuer and securitized. We note that in the Securitization Safe Harbor, the FDIC indicates its support for this form of risk retention. Our accounting committee has advised us that this form of risk retention would likely not require the sponsor of such transaction to consolidate the assets of the securitization issuer onto its balance sheet (even if the sponsor or an affiliate is acting as servicer), because the retained loans would not constitute an interest in the securitization issuer.

Our investor members do not support this form of risk retention because they believe it will be difficult to ensure that the sample of loans selected is in fact random and adequately represents the overall credit risk of the loans that are securitized. Our issuer members, however, believe there are several ways to mitigate investor concerns. For example, the procedure for selecting the sample of loans that will be retained by the sponsor could require that the loans to be retained should (a) initially be selected on a random basis from the same pool that is to be securitized, but (b) also have similar characteristics on a weighted average basis to the loans that are securitized, including as to parameters such as credit score and geographic diversity. Issuers note that the process of randomly selecting a cross section of assets is a time-tested and reliable practice commonly used for a variety of purposes across a broad range of industries.

Contractual Exposures

This form of risk retention would permit the sponsor or an affiliate to enter into a contractual obligation that would require such entity to make payments to the issuer in the event of credit losses on the securitized assets, up to a total amount equal to 5% (or other required percentage) of the aggregate principal balance of all assets included in the securitization trust. The obligation would result in the retention of credit risk without requiring the securitizer to own an interest in the securitization. The obligation could be structured to act as a vertical slice, a horizontal slice

or an originator's interest in the loans that are securitized, and could be set to expire when the duration requirement for the risk retention has been met.

Our accounting committee has advised us that for consolidation purposes the holder of the contractual exposure would generally be treated as if it held an actual interest in the securitization that corresponds to such contractual exposure. Therefore, depending on how the contractual exposure is structured, the consolidation consequences to the sponsor would be the same as those discussed above for either vertical or horizontal slice retention. The fact that the exposure is contractual and not an actual interest in the securitization does not change the consolidation analysis.

Contractual slice risk retention has the benefit of enabling the sponsor to assume the requisite percentage of credit risk of the assets underlying an RMBS transaction, without requiring the sponsor to assume other risks inherent in the ownership of securities (such as market value risk, liquidity risk and yield and prepayment risk). Such risks are separate and distinct from the statutory requirement for the sponsor to retain credit risk, and mandating that sponsors be subject to such risks would in no way advance the Act's goal of promoting sound underwriting practices. In addition, unlike actual ownership of securities, contractual risk retention would not require the entity holding such risk to make payments until such time as losses are actually incurred. This would result in greater availability of funds to lending institutions, which could be used to extend credit to additional consumers. Finally, contractual risk retention would enable originators to retain a portion of the credit risk for the loans they made without requiring such originators to purchase securities. In transactions with multiple originators, the contractual exposure could be structured such that each originator is only required to retain a portion of the credit risk related to the loans such originator made.

Our investor members are concerned that contractual risk retention is less meaningful than other forms of risk retention because the risk assumed is limited by the creditworthiness of the sponsor. However, in order to alleviate this concern, sponsors could be required to post cash or other collateral to secure their obligations to make payments under the terms of their contracts. Nevertheless, even with collateral, there is some risk that the collateral will not be kept available exclusively to cover such contractual exposure in the event of the bankruptcy or insolvency of the sponsor. This risk applies to insured depository institutions as well as non-regulated entities. For this reason, our investor members do not support this form of risk retention. However, our issuer members note that for sponsors that are subject to federal bankruptcy law, it may be possible to structure collateralization for contractual exposures so as to alleviate these risks.

IV. Hedging Prohibition

Section 941(b) of the Act includes a requirement that the regulations "prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain...." We respectfully request that the regulations clarify that this prohibition only applies to hedging the credit risk of the retained interest and does not apply to interest rate or currency swap arrangements that may be entered into with respect to the retained interest.

Furthermore, sponsors should not be precluded from entering into swaps that relate to the overall value of a particular broad category of securities.[23]

We further ask that the regulations clarify that the hedging prohibition will not prevent the securitizer from obtaining financing secured by any retained ownership interests in a securitization, or by any retained representatives samples, as long as such financing is full recourse to the securitizer. This is particularly important with respect to vertical slice ownership interests and representatives samples, which are assets that normally would be partially financed as opposed to being 100% funded with capital. For example, a vertical slice would consist largely of highly rated securities which would be eligible for financing.

Permitting such financing on a full recourse basis would not result in hedging or transferring of the credit risk embedded in such retained interests. The securitizer would remain fully exposed to the credit risk.

On the other hand, prohibiting such financing would go beyond the Congressional mandate of requiring a securitizer to retain credit risk, because it would require funding of such interests with either unsecured debt, deposits (for depository institutions) or capital. To the extent that unsecured debt or deposit funding sources were not available, such a prohibition would effectively impose a capital requirement on securitizers that are unregulated entities, and an additional capital requirement on securitizers that are regulated entities with capital requirements.

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ASF very much appreciates the opportunity to provide the foregoing views in connection with this joint rulemaking process. We are available at your convenience to discuss our proposals. Should you have any questions or desire any clarification concerning the matters addressed in this letter, please do not hesitate to contact me at 212.412.7107 or tdeutsch@americansecuritization.com. You may also contact Evan Siegert, ASF Associate Director, at 212.412.7109 or esiegert@americansecuritization.com or ASF's outside counsel on this matter, Stephen S. Kudenholdt of SNR Denton US LLP at 212.768.6847 or stephen.kudenholdt@snrdenton.com.

Sincerely,

Tom Deutsch
Executive Director
American Securitization Forum

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[23] We note that the Commission took the position in the Proposed ABS Rules that interest rate and currency swaps, as well as swaps relating to the overall value of a broad category of securities, should not be netted against the risk required to be retained.

American SECURITIZATION FORUM®

EXHIBIT A

Section 941 Regulation of Credit Risk Retention
Title IX, Subtitle D of Dodd-Frank
Proposed Definition of Qualified Residential Mortgage Exemption

General. Our RMBS issuer and investor members agree on all aspects of the following framework for a qualified residential mortgage ("QRM") except if indicated otherwise. The determination that a loan is a QRM would be made at origination and only revisited if the loan is modified prior to securitization. The same standards would apply to private-label and GSE loans. Issuers and investors have differing views on whether loans within government initiatives should be considered QRMs. Issuers believe that any loan within a government modification or refinance initiative should be a QRM (HAMP, HARP, FHA Short Refinance, etc.). Investors believe that these programs should be excluded. We have set forth separate standards for new originations and streamlined refinances.

- New Origination
  - Income Verification
    - **Issuers/Investors:** 12/24 months income verification, as supported by W-2s in addition to any of the following: pay stubs, bank statements, tax returns, employment contracts, statements of bonus award and/or a 4506-T (IRS form enabling lenders to obtain borrower tax returns).
    - For employees who have returned to the workplace during the prior 12/24 months, income verification of the type described in the preceding sentence will cover the period of time during the prior 12/24 months in which the borrower was employed and/or a 4506-T. For newly employed borrowers, same as the preceding sentence so long as borrower was either attending school or training program immediately prior to their current employment history.
    - For self employed. **Issuers/Investors:** 1/2 years tax returns plus a 4506-T.
    - Income should also be able to be imputed based on the actual income of a borrower's verified assets provided that the amount of income so imputed is calculated using a specified formula that is designed to include only well-qualified borrowers. ASF will provide such a formula at a later date.
  - Employment Verification
    - Direct independent verbal and written verification with a third party (which can be either an employer or a vendor that can supply verification) of the borrower's current employment.
    - For self employed: Must employ a commercially reasonable process to confirm existence of the business (for example, verifying licenses, telephoning the business, checking phone listings, CPA certification, etc.).

- Asset Verification
  - 2 months of bank statements/balance documentation (written or electronic) for liquid assets (or gift letter) that are used to qualify the loan.
    - Documentation should be no more than 3 months old as of date of loan application.
    - 2 Months PITI (principal, interest, taxes and insurance)
- Equity in the Property
  - Mortgage insurance required if LTV over 80%.
  - Down-payment. **Issuers:** minimum of 5% from borrower's own funds or equity in the property. **Investors:** minimum of 20% from any funds other than second liens.
- Debt-to-Income
  - Front-End. **Issuers** propose: 38%. **Investors** propose: 28%.
  - Back-End. **Issuers** propose: 45%. **Investors** propose: 36%.
    - Back-end would include any debt and non-discretionary financial commitments, including but not limited to, court ordered payments.
    - Can adjust back-end if certain specified compensating factors exist that are objective and quantifiable and can be disclosed.
      - An example would be verified unencumbered assets. ASF will provide a complete list of such compensating factors at a later date.
- Property Valuation
  - For existing homes, the determination of value for the subject property must have been performed within 4 months of the closing of the loan.
  - For new construction, the determination of value for the subject property must have been performed within 6 months of the closing of the loan with a recertification of value at or near closing.
- Additional ARM Requirements
  - Underwrite to fully-indexed rate, which is the margin plus the value of the index at origination of an ARM loan,[1] subject to the following exceptions.
    - (i) Intermediate term ARMs (3/1s and 5/1s)
      - For 3/1s, qualify at fully indexed rate or note rate plus 2%, whichever is higher.
      - For 5/1s, qualify at fully indexed rate or note rate, whichever is higher.
    - (ii) Long term ARMs (7/1s and 10/1s)
      - Qualify at fully indexed rate or note rate, whichever is higher.
  - Loans must be subject to each of the following interest rate caps: (i) up to

[1] An example of a typical ARM: a 5/1 ARM will have a fixed rate for 5 years and then adjust every year subject to a 5/2/5 cap structure (first reset/periodic/life) with 2.25% margin over the index rate. Suppose the initial rate during first 5 years was 3.25%, it will then adjust in month 61 based on LIBOR, subject to the first reset cap and the life cap. Thereafter, the periodic cap will limit the mortgage rate movement to 2.00% from the rate over the last 12 months regardless of whether LIBOR surges or plummets. For example, the loan could adjust from 6% to 8% or from 6% to 4%. The life cap of 5.00% makes the highest rate possible during any period 8.25% (3.25% + 5.00%).

5% first reset cap, (ii) up to 2% periodic cap and (iii) up to 6% life cap.

- Prohibited Loan Types
  - Balloons, negative amortization, prepayment penalties, payment option ARMS, short-term ARMs (1/1s and 2/1s) and "high cost" loans (as per applicable then-current federal guidelines).

- Streamlined Refinance
  - Same requirements as New Origination except as modified below.
  - Loan must be originated or serviced by party executing the streamlined refinance.
  - Re-verify employment
  - Re-verify income:
    - **Issuers** believe that this should only be required if the monthly payment increases by at least 20% (which should also be the standard for "qualified mortgage" under TILA).
    - **Investors** believe that income should be re-verified in all cases.
  - Do not need to re-verify assets due to established payment history.
  - Payment history of 24 months (no more than one 30-day delinquency in last 12 months and either (i) no more than two 30-day delinquencies in last 24 months or (ii) no 60-day delinquencies in last 24 months).
  - Current updated appraisal or property valuation.
  - **Investors** believe that cash-out refinances should be prohibited under this framework. To execute a cash-out, must re-underwrite the loan.