



Residential Mortgage Risk Retention Proposed Regulations Summary

March 30, 2011

- The Federal Deposit Insurance Corporation (FDIC) and the Board of Governors of the Federal Reserve System (Federal Reserve) issued proposed rules yesterday to implement the risk retention provisions of the Dodd-Frank Act which require securitizers to hold five percent of the credit risk of any asset they securitize.
- **Qualified Residential Mortgage (QRM) Criteria:** The Dodd-Frank Act requires regulators to establish criteria for a class of mortgages that would be exempt from risk retention requirements. The proposal includes the following QRM eligibility criteria:
 - *Eligible:* Owner-occupied, 1-4 family, FRMs, ARMs if the rate cannot increase more than two percent in 12 months or six percent over life of loan; second liens in refinance transactions.
 - *Ineligible:* Mortgages with prepayment penalties, balloons, negative amortization or interest-only features. Also, reverse, bridge, construction and time share loans and loans with, terms exceeding 30 years or less than 12 months, piggybacks (for purchase money).
 - *Restrictions:* Points/fees cannot exceed three percent of the loan amount.
 - Maximum front-end and back-end debt-to-income ratios of 28 percent and 36 percent, respectively.
 - No less than 20 percent borrower down payment, i.e., maximum loan-to-value ratio of 80 percent for purchase loans and 75 percent combined LTV for refinance transactions, reduced to 70 percent for cash-out refinances. In addition to a 20 percent down payment, the borrower must have cash to pay closing costs. The “down payment” requirement permits gifts and qualified down-payment assistance programs.
 - Written appraisal required (i.e., no AVMs allowed).
 - Borrowers must not have any 60-day delinquency in the past two years, or bankruptcy, foreclosure, short-sale in the past 36 months.
 - The QRM definition does not include provisions for mortgage insurance, but asks the question whether mortgage insurance or other credit enhancements should be included in the final rule.
 - Mortgage assumability provisions prohibited.
- **Mortgage servicing provisions.**
 - QRM transaction documents must obligate the creditor to have servicing policies and procedures to mitigate the risk of default (within 90 days of delinquency) and to take loss mitigation action, such as engaging in loan modifications, when such loss mitigation is NPV positive. The Loss mitigation

policies and procedures must account for the borrower's ability to repay and other underwriting criteria.

- Servicing compensation must support loss mitigation.
 - Policies and procedures must address second liens. The creditor must include in transaction documents that it will not sell, transfer, or assign servicing rights unless the transferee abides by the policies of the creditor.
 - The creditor must disclose its default mitigation policies/procedures to the borrower at or prior to closing and to investors prior to the sale of the ABS.
- **Possible QRM Alternative:** The proposal seeks comment on an alternative approach to defining the QRM more broadly and the risk-retention provisions more narrowly. For example, the regulators ask if 90 percent LTV, 10 percent down payment and 33/41 DTI with a corresponding higher risk retention amount and only vertical slice permitted would be preferable,
 - **GSE Securities Exempt:** The regulators propose a special risk retention exemption for securities issued by Fannie Mae and Freddie Mac while these entities are in conservatorship or receivership.
 - **Other Exemptions:** The proposal incorporates the statutory risk retention exemptions for mortgages issued/guaranteed by FHA, VA, RHS and the Farm Credit Administration.
 - **Form of Risk Retention:** The proposed rule provides several options for the form in which a securitization sponsor may retain risk. These include:
 - A five percent "vertical" slice of the ABS interests, whereby the sponsor retains a specified *pro rata* piece of each class of interests issued in the transaction (that is, the sponsor must hold five percent of each tranche);
 - A five percent "horizontal" first-loss position, whereby the sponsor retains a subordinate interest in the issuing entity that bears losses on the assets before any other classes of interests;
 - An "L-shaped interest" whereby the sponsor holds at least half of the five percent retained interest in the form of a vertical slice and half in the form of a horizontal first-loss position;
 - A "seller's interest" in securitizations structured using a master trust collateralized by revolving assets whereby the sponsor holds a five percent separate interest that participates in revenues and losses on same basis as the investors' interest in the pool of receivables;
 - A representative sample, whereby sponsor retains a five percent representative sample of the assets to be securitized; or
 - For certain "eligible" single-seller or multi-seller asset-backed commercial paper conduits collateralized by loans and receivables and covered by 100 percent liquidity guarantee from a regulated bank or holding company, a five percent residual interest retained by the receivables' originator-seller. This option would not be available to ABCP programs that operate as SIVs or securities arbitrage programs.
 - **Certification Required:** For all of the risk retention methods (i.e., horizontal, vertical etc.) the securitizer must certify compliance AND have a report available for review prior to issuance that indicates the dollar amount and percentage of risk retained and explains its methodology for calculating the amount.

- Under the “representative sample” method of risk retention, the securitizer’s methodology must obtain a third-party audit of compliance initially, and any time changes are made.
- **Excess Spread Prohibited:** In addition to the base credit risk retention requirement, the proposed rule prohibits issuers from receiving compensation in advance for excess spread income to be generated by securitized assets over time. The proposed rules accomplish this by imposing a “premium capture cash reserve account” mechanism designed to prevent a securitizer from structuring an ABS transaction in a manner that would allow the securitizer to take an up-front profit on a securitization (before any unexpected losses on the securitized assets appeared) that would pay the sponsor more up front than the cost of the risk retention interest it is required to retain.
- **Duration:** There is NO duration provision; i.e. risk retention exists for the life of the loan.
- **Risk Allocation:** Risk retention applies to the securitizer, unless it is allocated voluntarily to the originator by contract. But it does NOT apply to an aggregator/conduit.
- The regulators ask if there are other classes of non-QRM mortgages that should have less than five percent risk retention requirement.
- **Next Steps:** The Securities and Exchange Commission, Federal Housing Finance Agency and Office of the Comptroller of the Currency are planning to adopt the same proposal this week. Comments must be submitted by June 10, 2011.
- The proposal is extensive and includes more than 174 questions for public response including its effects on the availability of credit particularly to low and moderate income borrowers.
- MBA will work closely with its members and other stakeholders to respond to this proposal. We believe in its present form it offers a far too narrow door to affordable private mortgage financing for generations to come.