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Credit Risk Retention Rules Finalized

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Six federal agencies have finalized long-anticipated joint rules imposing risk retention, or "skin-in-the-game," requirements for securitizations. The new rules, when they become effective over the next two years, will impose significant new costs and obligations on a wide range of securitization structures. The risk retention rules come on the heels of a number of other Dodd-Frank reforms that have hit the securitization markets in recent months, including the Volcker Rule, Regulation AB II, and Dodd-Frank derivatives reforms.

The risk retention rules are required by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which added Section 15G of the Securities Exchange Act of 1934. The joint regulations were adopted by the US Securities and Exchange Commission ("SEC"), Office of the Comptroller of the Currency ("OCC"), Board of Governors of the Federal Reserve System ("Fed"), Federal Deposit Insurance Corporation ("FDIC"), Department of Housing and Urban Development ("HUD") and the Federal Housing Finance Agency ("FHFA"), together, the "Agencies."[1]

The rules were initially proposed in 2011 and re-proposed in 2013. The initial proposal in April 2011 was subject to comments from more than 10,500 groups and individuals, much of it negative. The re-proposal in September 2013 was also the subject of significant industry comment, especially as it related to cash flow restrictions on the eligible horizontal residual interest risk retention option and the treatment of collateralized loan obligations ("CLOs"). The final rules generally follow the re-proposal with some technical revisions. Significantly, the Agencies did not adopt the cash flow restrictions, but rejected industry requests for additional exemptions for certain categories of securitization transactions, most notably open-market CLO transactions.

1 The final rules have not yet been published in the Federal Register, but are available at: http://www.federalreserve.gov/aboutthefed/boardmeetings/bcreg20141022a1.pdf. The proposal was published at 76 Fed.Reg. 83 (April 29, 2011) and the re-proposal was published at 78 Fed.Reg. 183 (September 20, 2013)

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Risk Retention Requirement

In general, the final rules require that a "sponsor" of an asset-backed securitization (ABS) transaction retain credit risk of the securitized assets in one of several permitted forms. The "sponsor" for this purpose is a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, to the issuing vehicle. In certain cases, the risk may be retained instead by an "originator" of the relevant assets, which is defined as a person who originates the underlying asset and sells it directly or indirectly into the securitization.

The final rules allow sponsors to choose from the following alternative methods of retaining the required credit risk:

- Retaining a 5% "eligible vertical interest" or "vertical strip of risk" (a proportionate 5% interest in every tranche of a securitization),
- Retaining a "eligible horizontal residual interest" (a proportionate interest in the equity/first loss tranche of a securitization), with a market value at least equal to 5% of the market value of all the securities issued in the ABS transaction, or
- Combined vertical and horizontal interests for which the sum of the percentage held as a vertical strip and the percentage of the market value of the eligible horizontal residual interest compared to all the issued ABS securities must be at least 5%.

As compared to the proposed rules, the final rules eliminate a proposed cash flow restriction on eligible horizontal residual interests. The rules also eliminate the need to perform a fair value calculation for purposes of determining an eligible vertical interest (but retain such requirement for a horizontal interest).

The final rules also lay out certain additional or modified risk retention methods for specific types of transactions, including asset-backed commercial paper conduits, commercial mortgage-backed securities, securitizations sponsored by Fannie Mae and Freddie Mac, open-market CLOs, and tender option bond transactions.

As under the proposed rules, retained risk cannot be hedged or transferred, in order to preserve the sponsor's economic exposure to the assets underlying the ABS and avoid weakening the sponsor's incentive to select assets with appropriate diligence.

Exemptions

Exemptions to the 5% risk retention requirements have been the subject of much controversy since the initial proposal in 2011. The final rules include the following exemptions:

- Certain residential mortgage-backed transactions where the underlying loans meet specified underwriting criteria (referred to as "qualified residential mortgages" or QRMs).

- Mortgages that qualify for sale to Fannie Mae and Freddie Mac, as long as they are operating with the capital support from the US government.
- Securitizations of certain non-QRM residential mortgages, commercial loans, commercial mortgages, and auto loans that satisfy stringent underwriting criteria.
- Certain types of community-focused residential mortgages that are not eligible for QRM status in the Regulation.

The final rules generally align the QRM definition with the Qualified Mortgage ("QM") definition as defined in rules of the Bureau of Consumer Financial Protection ("CFPB"). They also allow for multi-family homes with up to four units to be included within the definition of residential mortgages. The Agencies did not follow requests to exempt single-borrower or single-credit ("SBSC") transactions from the risk retention requirements. Despite requests by commentators, the Agencies also did not provide a broad exemption for so-called open-market CLOs, in which the underlying assets are generally acquired in the market rather than originated by a transaction sponsor.

In particular, the Agencies rejected the expressed concern that many CLO managers, who will be treated as sponsors for purposes of the rules, do not have sufficient assets to hold the required portion of the CLO securities to satisfy the risk retention requirements. The final rules retain a limited exception where the originators of the securitized loans themselves satisfy the risk retention requirements. It is not clear how readily this exemption can be used in the CLO market today. As a result, there are significant concerns about how the final rules will affect the CLO market.

Implementation and Timeline

The risk retention requirement will become effective one year following publication of the final rules in the Federal Register for securitization transactions collateralized by residential mortgages and two years following publication of the final rules for all other securitization transactions. The requirement will only apply to new securitizations created after the effective date.

The final rules authorize the Agencies to provide additional exemptions as they determine appropriate. The rules also contemplate a periodic review of the following components to consider whether modifications would be necessary:

- Definition of QRM,
- Exemptions for certain community-focused residential mortgages, and
- Exemptions for certain residential mortgage loans.

International Considerations; US & EU Comparison

The final rules provide an exemption from the risk retention requirement for certain privately offered non-US securitization transactions where no more than 10% of the value of all classes of securities are sold to US persons and certain other conditions are satisfied. Market participants will need to evaluate the extent to which securitization structures can take advantage of this exemption. To the extent market participants do so, such an approach may lead to bifurcation or fragmentation of the relevant markets.

It also bears noting that the EU's credit risk retention rule has already come into effect in July 2014, in accordance with the final Regulatory Technical Standards (RTS) rulemaking.[2] The EU standards contain different requirements and different exemptions as compared to the US final rules. Unless an exemption is available, a securitization sold in both the

US and the EU may be subject to risk retention requirements under both rules. This possibility is likely to further complicate transaction structuring, and may also lead to market fragmentation.

We will continue to provide updates of developments in this area, including a more detailed analysis of the final risk retention rules.

[2] The Final Regulation was published on the Official Journal of the European Union on June 13, 2014 and is available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L:2014:174:FULL&from=EN (See page 16).

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