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RMBS Risk Retention is Here

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RMBS Risk Retention is Here

It's official. Risk retention became effective for residential mortgage-backed securities ("RMBS") on December 24, 2015. Since the final rules (the "Rules")[1] were issued, there has been a lot of talk throughout the broader securitization industry regarding risk retention structures.[2] There are unique considerations for various asset types. What is patently obvious is that there is no one-size-fits-all solution to risk retention. Solutions must be structured to fit the unique platform needs of the individual securitization sponsors. Even within asset classes, variation will be the norm. This article recaps some of the risk retention requirements for RMBS and highlights some unique considerations for the RMBS industry.

Overview of the Risk Retention Requirement

The sponsor of a residential mortgage loan securitization (or a majority-owned affiliate thereof) must retain an eligible vertical interest or eligible horizontal interest, or a combination thereof, amounting to at least 5% of the credit risk of the securitized assets.[3] In the case of an eligible vertical interest, the 5% is measured by face or notional amount.[4] In the case of an eligible horizontal interest, the 5% is measured by fair value.[5] In lieu of retaining securities, the sponsor may establish a cash-funded eligible horizontal reserve account in an amount equal to the fair value of the eligible horizontal residual interest, or part thereof.[6] If there is more than one sponsor, each sponsor is responsible for ensuring that at least one of the sponsors satisfies the risk retention requirements.[7]

One option that a sponsor could use to reduce its risk retention obligations is to have originators of its securitized assets hold a portion of the sponsor's eligible interest.[8] This option has some key requirements.[9] First, the originator must acquire and retain the sponsor's eligible interest at the closing of the securitization,[10] paying either cash or

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[1] Credit Risk Retention; Rule, 79 Fed. Reg. 77,602 (2016). The Rules were issued by joint action of the Federal banking agencies, the Securities and Exchange Commission, the Department of the Housing and Urban Development and the Federal Housing Finance Agency (collectively referred to herein as the "Agencies").

[2] *See Dechert OnPoint,* The Rise of the C-MOA (July 2015); *Dechert OnPoint,* U.S. Risk Retention Final Rule: Capitalized Manager Vehicles, Majority Owned Affiliates and Other FAQs (January 2015); *Dechert OnPoint,* U.S. Risk Retention Final Rule: Playing it Forward for CLOs (October 2014); *Dechert OnPoint,* Credit Risk Retention Final Rule: Steering CMBS through the Regulatory Wake (October 2014); *Dechert OnPoint,* Final Credit Risk Retention Rules Adopted for Asset Backed Securities and Residential Mortgage Backed Securities (October 2014).

[3] 12 C.F.R. § 244.4(a) (2016).

[4] § 244.4(a)(1).

[5] § 244.4(a)(2).

[6] § 244.4(b).

[7] § 244.3(b).

[8] § 244.11(a).

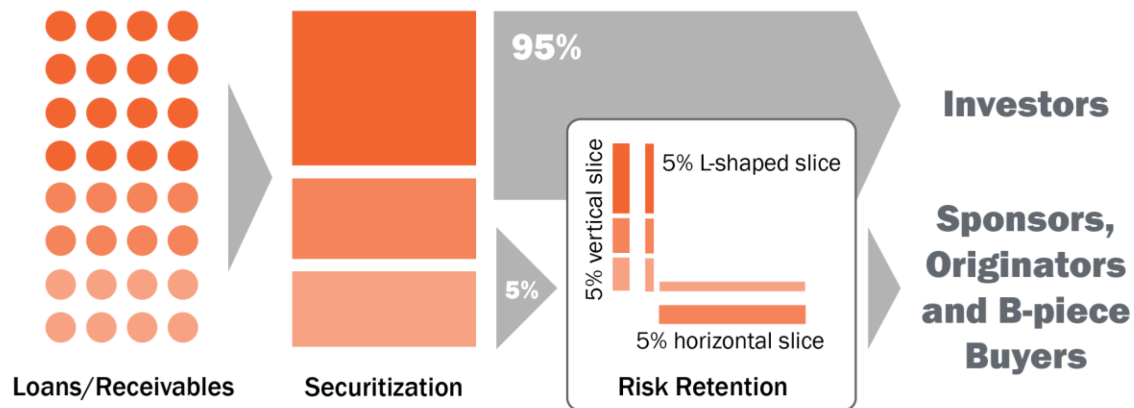
[9] Moreover, certain disclosures regarding the originator and the acquisition of the eligible interests are required. *See* § 244.11(a)(2). In addition to the listed requirements, the originator would also be required to comply with the hedging, transfer and pledging requirements of § 244.12 as if it were the retaining sponsor of the held eligible interests. § 244.11(a)(3); *see also* "**Hedging and Financing.**"

[10] § 244.11(a)(1).

through a reduction of the purchase price received by the originator from the sponsor in connection with the sale of the originated assets, at a price equal to the amount of the reduction in the sponsor's risk retention obligation.[11] Second, the originator must hold at least 20% of the risk retention amount required to be retained by the sponsor.[12] Third, the proportion of eligible interests held by an originator cannot exceed the proportion of loans, by unpaid principal balance, it originated in the pool.[13]

Final Rule. Open questions.

The Dodd-Frank credit risk retention rules took effect for RMBS on December 24, 2015 and will take effect for all other ABS on December 24, 2016. Concerns about how to comply with these risk retention rules remain outstanding.



Concerns by asset class

CLO	CMBS	ABS
How will Sponsors (i.e., CLO Collateral Managers) capitalize their 5% slice?*	How will Sponsors comply with the requirements?	Varies based on asset type.

*For emerging solutions, please refer to Dechert's OnPoints located at www.dechert.com/risk_retention

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[11] § 244.11(a)(1)(iv).

[12] § 244.11(a)(1)(iii).

[13] § 244.11(a)(1)(ii).

Who is a Sponsor?

For purposes of the Rules, a sponsor is defined as "a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity."[14] In its commentary, the Agencies note that the definition of "sponsor" is consistent with the definition of that term in Regulation AB promulgated under the Securities Act of 1933 as well as with the definition of "securitizer" in section 15G of the Exchange Act.[15]

In contrast with the existing definitions, however, the Agencies imply in their commentary that there are additional requirements for sponsors. Certain hedge funds or REITs, for example, may not qualify as sponsors under the Rules. The Agencies explain that "an entity that serves as a pass-through conduit for assets that are transferred into a securitization vehicle, or that only purchases assets at the direction of an independent asset or investment manager, only pre-approves the purchase of assets before selection, or only approves the purchase of assets after such purchase has been made would not qualify as a 'sponsor' . . . because, such activities, in and of themselves, do not rise to the level of 'organization and initiation'."[16] Further, the Agencies note that "negotiation of underwriting criteria or asset selection criteria or merely acting as a 'rubber stamp' for decisions made by other transaction parties does not sufficiently distinguish passive investment from the level of active participation expected of a sponsor."[17]

While one could argue that these additional requirements in the commentary have the effect of mere dicta, we expect that RMBS issuers will seek to address this commentary head-on. Externally managed hedge funds, who are aggregating residential mortgage loans and plan to securitize, can approach the requirements in a variety of ways but the key to the structuring considerations is ensuring that the sponsor is the one that actually "organizes and initiates" the securitization.

For example, in order to have the hedge fund itself serve as sponsor, it may be necessary to move securitization staff from the fund's external manager to the fund instead, such that the fund itself has officers who are directly responsible for organization and initiation of the securitization. Alternatively, the hedge fund could establish a subsidiary, which would need to be staffed with the appropriate officers directly responsible for organizing and initiating the securitization, to serve as the sponsor of the fund's securitization.[18] Whichever fund entity acts as the sponsor could then establish a majority-owned affiliate ("MOA") to hold the sponsor's risk retention obligations. Economic interests in the MOA could then be offered to third-party investors to mitigate the fund's exposure.[19] These are just a few examples of the many different structures that can be utilized to comply with the Rules. It is important for any potential structure to also be vetted for accounting, tax law and investment company act considerations.

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[14] § 244.2.

[15] 79 Fed. Reg. at 77,608—9.

[16] *Id.* at 77,609.

[17] *Id.*

[18] *See Dechert OnPoint,* U.S. Risk Retention Final Rule: Capitalized Manager Vehicles, Majority Owned Affiliates and Other FAQs (January 2015) (discussing the CMV option, which bears some structural similarities to the subsidiary option discussed here).

[19] § 244.3(a).

Hedging and Financing

The risk retaining party is generally not permitted to hedge its risk retention position in any way that reduces or limits its financial exposure.[20] In addition, the risk retained position cannot be financed in a non-recourse financing.[21] Permitted hedging includes interest rate and foreign exchange rate hedging.[22] In addition, the risk retaining party is permitted to acquire positions in an index of instruments that includes the asset-backed securities issued in the transaction in which it retains risk, so long as such transaction does not make up more than 20% of the index on a dollar-weighted average basis.[23]

Term of Risk Retention

Sponsors of RMBS are required to maintain their risk retention obligations with respect to each securitization until the later of (1) the date on which the total unpaid principal balance of the residential mortgage loans included in the securitization has been reduced to 25% of the total unpaid principal balance of residential mortgage loans included in the securitization as of the closing of the securitization transaction or (2) 5 years, but in any case, not longer than 7 years.[24]

Exemptions

The Rules provide for certain exemptions from risk retention requirements. The primary exemptions related to RMBS are for securitizations of "qualified mortgages" as defined in section 129C of the Truth in Lending Act[25], mortgage loans that are secured by three-to-four unit owner-occupied dwellings that otherwise qualify as "qualified mortgages" and "community-focused residential mortgages."[26] In addition, securitizations of qualifying seasoned loans are not subject to risk retention.[27] Risk retention requirements also do not apply to securitizations of mortgage loans that are insured or guaranteed by the United States of an agency of the United States.[28] Also exempt from risk retention are certain securitizations that are sponsored and fully guaranteed by the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation operating under the conservatorship or receivership of the Federal Home Loan Mortgage Corporation with capital support from the United States or any limited-life regulated entity succeeding to the charter of either the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation, provided that such entity is operating with capital support from the United States.[29] Lastly, exemptions apply to re-

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[20] § 244.12(b).

[21] § 244.12(b).

[22] § 244.12(d).

[23] § 244.12(d)(2)(ii).

[24] § 244.12(f)(2).

[25] 15 U.S.C. § 1639c (2016).

[26] § 244.13(b)(3), § 244.19(f) and § 244.19(g). "Community-focused residential mortgages" are generally residential mortgage loans to lower and middle income borrowers made through state housing agency programs and other community lender programs.

[27] § 244.19(b)(7).

[28] § 244.19(b)(1).

[29] *See* § 244.8.

securitization transactions that satisfy certain requirements, including that the underlying securitization or securitizations are in compliance with, or exempt from, risk retention requirements.[30]

Conclusion

We are assisting numerous securitization market participants, in the RMBS space as well as in other asset classes, in structuring their risk retention solutions. The above discussion provides just a basic overview of the Rules as they relate to RMBS. We encourage you to contact us with any question you might have and would be delighted to discuss how risk retention requirements impact your organization in greater detail.

[30] §§ 244.19(b)(5)—(6).

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