August 29, 2013

Agencies Propose Revised Risk Retention Rule

On August 28, 2013, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the U.S. Securities and Exchange Commission, the Federal Housing Finance Agency and the Department of Housing and Urban Development (collectively, Agencies) issued a notice of proposed rulemaking (Proposed Rule) in connection with the risk retention requirement mandated by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The Proposed Rule can be found here.

Background

The risk retention requirements of Section 941 of the Dodd-Frank Act are intended to align the interests of securitizers with those of other securitization transaction participants by requiring securitizers to retain some of the credit risk in the assets they securitize, or to have "skin in the game." Section 941 added Section 15G to the Securities Exchange Act of 1934, which requires the Agencies to prescribe risk retention rules. Section 15G also generally requires a securitizer to retain no less than 5 percent of the credit risk in assets it sells into a securitization and prohibits a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain, subject to limited exemptions. The Proposed Rule follows the initial rule proposal and request for comment by the Agencies released in April 2011 (the Original Proposal). As described below, the Proposed Rule reflects comments received on the Original Proposal and re-proposes the risk retention rules with a number of modifications.

The Original Proposal and the Proposed Rule both include alternatives for structuring the economic interest required to be retained and the application of the rules to specific types of securitization transactions, as well as exemptions from the standard 5 percent risk retention requirement. The Proposed Rule would permit a sponsor to retain any combination of horizontal and/or vertical economic interest in a securitization transaction, provided that those interests generally equal at least 5 percent of the "fair value" of the securitization transaction in the aggregate. The commentary to the Proposed Rule also includes a "menu of options" for permissible forms of risk retention that takes into account transaction-specific features of securitization transactions involving revolving master trusts, asset-backed commercial paper conduits (ABCPs), commercial mortgage-backed securities (CMBS), open market collateralized loan obligations (CLOs), mortgage-backed securities issued and guaranteed (with respect to payment of principal and interest) by government-sponsored enterprises (GSEs) and municipal bond repackaging securitizations.

As mentioned above, Section 15G allows for certain exemptions from the standard 5 percent risk retention requirement. One significant exemption is for securities entirely collateralized by "qualified residential mortgages" (QRMs), which are loans deemed to have a lower risk of default. In addition, as contemplated by Section 15G, both the Original Proposal and Proposed Rule provide for reduced risk retention requirements for qualifying commercial loan, commercial real estate loan and auto loan securitizations.

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

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Key Differences Between the Original Proposal and the Proposed Rule

The Proposed Rule modifies and makes various changes to the risk retention requirements in the Original Proposal, including the following:

- **QRM definition** – simplifies the QRM exemption by defining QRMs to have the same meaning as the term "qualified mortgage," as defined by the Consumer Financial Protection Bureau**.**
- **Calculation Based on Fair Value** – proposes that the risk retention requirement for a securitization transaction without an exemption be based on fair value (rather than par value, as in the Original Proposal).
- **Premium Capture Cash Reserve Account Requirement** – removes the premium capture cash reserve account requirement included in the Original Proposal, which was intended to capture the premium received by a securitizer on the sale of the tranches that monetize the excess spread in a securitization transaction and required that such amounts be placed into a separate account that would be used to cover losses.
- **Sale and Hedging Restriction** – provides that the previously proposed restrictions on transfer and hedging of credit risk required to be held by a securitizer would terminate after specified time periods rather than continuing for the life of the transaction.
- **Flexibility in Structuring Risk Retention** – proposes to provide flexibility for a sponsor to combine an eligible horizontal retained interest with an eligible vertical interest that together meet the 5 percent risk retention requirement, as opposed to holding an all horizontal or all vertical interest, or an equal combination of horizontal and vertical interests as required in the Original Proposal.
- **Blended Pools** – introduces the concept of "blended pools" for securitization of commercial loans, commercial real estate loans and auto loans such that qualified loans satisfying certain underwriting requirements could be securitized in the same pool as non-qualifying loans of the same asset class and which would permit a reduced required risk retention percentage as low as 2.5 percent.
- **Options for CLOs** – proposes a new risk retention option for CLOs pursuant to which lead arrangers of loans purchased by open market CLOs may fulfill the risk retention requirement instead of the CLO managers/sponsors; for CLOs not meeting the definition of an open market CLO, the manager/sponsor would be required to fulfill the risk retention requirement.
- **Municipal Bond Repackaging Transactions** – adds risk retention provisions specific to municipal bond repackagings such as tender option bonds (TOBs).
- **Representative Sample Option** – removes the option included in the Original Proposal that would have enabled sponsors to satisfy the risk retention requirement by retaining a randomly selected representative sample of the securitized assets.

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The Proposed Rule states that comments must be received by October 30, 2013. The risk retention requirement will become effective one year after the date on which final rules are published in the Federal Register for residential mortgage-backed securities transactions and two years after such date for other securitization transactions. A more detailed memorandum on the Proposed Rule will follow.