Regulators Adopt Final Risk Retention Rules for Asset-Backed Securities

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In October 2014, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the Federal Housing Finance Agency and the Department of Housing and Urban Development adopted a final set of rules implementing the credit risk retention requirements of the Dodd-Frank Act. The objective of the rules is to align the interests of securitizers with those of other transaction participants by requiring them to retain a specified percentage of the credit risk of the assets they securitize. The final rules, which follow two sets of proposed rules — in 2011 and 2013 — were published in the Federal Register on December 24, 2014, and compliance with the rules with respect to asset-backed securities (ABS) collateralized by residential mortgages is required by December 24, 2015, and with respect to all other classes of ABS is required by December 24, 2016.

The final rules generally require a sponsor of an ABS transaction or its majority-owned affiliate to retain an economic interest equal to at least 5 percent of the aggregate credit risk of the assets collateralizing an issuance. In some circumstances a portion of the risk retention may be retained by the originator of the assets that collateralize the ABS. The standard forms of risk retention are an "eligible horizontal residual interest" and an "eligible vertical interest."

An "eligible horizontal residual interest" must have the most subordinate claim to payments of both principal and interest by the issuing entity and, if an issuing entity has insufficient funds to satisfy its obligation to pay interest and principal due, requires the holder to absorb any shortfalls prior to any reduction in the amounts payable to any other ABS interest.

An "eligible vertical interest" is an interest in each class of ABS interests in the transaction that constitutes the same portion of each class or a single vertical security entitling the holder to a specified percentage of the amounts paid on each class of ABS interests in the issuing entity.

A sponsor may satisfy the risk retention requirements by retaining a combination of eligible horizontal residual interests and eligible vertical interests so long as the combined percentages equal at least 5 percent. A sponsor also may fund an eligible horizontal cash reserve account held by a trustee in cash or cash equivalents. An eligible horizontal residual interest (or the amount held in an eligible horizontal cash reserve account) is subject to a "fair value" valuation in accordance with generally accepted accounting principles and the sponsor's valuation methodology must be disclosed.

Special risk retention alternatives are available for revolving-pool securitizations, asset-backed commercial paper conduits, commercial mortgage-backed securities, government-sponsored enterprises, open market collateralized loan obligations and qualified tender option bonds (note that the rules apply to both publicly and privately issued "asset-backed securities," as defined in the Securities Exchange Act of 1934, and that the broad definition encompasses some securities that have not traditionally been considered to be ABS). Exemptions also exist for certain types of assets and transactions, the most significant of which is the exemption for qualified residential mortgages (QRMs). A pool comprised

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entirely of QRMs has no retention requirement. The definition of QRM is linked to the definition of "qualified mortgage" (QM) in the Truth in Lending Act, so changes made by the Consumer Financial Protection Bureau to the QM definition will automatically modify the QRM definition absent the risk retention regulators acting to prevent such modification.

The final rules generally prohibit the transfer or pledging of any interest that the sponsor is required to retain under the rules except to an entity that is a majority-owned affiliate which itself is subject to the same prohibitions, until any applicable sunset date. However, the sponsor or its permitted affiliate may pledge the retained interest as collateral for an obligation that is full recourse to the sponsor or the affiliate. For residential mortgage-backed security (RMBS) transactions, the prohibitions on sale or pledging expires no later than seven years after the closing date or the later of five years after the closing or the date on which the total unpaid principal balance of the residential mortgages has been reduced to 25 percent of the original balance. For other ABS transactions, the prohibitions on sale or pledging expire on or after the date that is the latest of (1) the date on which the total unpaid principal balance of the securitized assets has been reduced to 33 percent of their original balances, (2) the date on which the total unpaid principal obligations of the ABS interests have been reduced to 33 percent of the total ABS interest on the closing date, and (3) two years after the closing date.

The risk retention rules were designed to address problems in the ABS markets that emanated from the RMBS sector. However, the exclusion for QRMs means that risk retention will not be required for most RMBS transactions. For certain asset classes, the final risk retention rules will give credit for interests that have been commonly retained, such as the seller's interest in credit card securitizations and retained subordinated securities held by securitizers of auto ABS. However, for some other asset classes the risk retention requirements will necessitate restructuring and will impose new costs. In all cases, issuers will be subject to new disclosure requirements with respect to the retained interests. Asset classes that will be particularly adversely affected by the risk retention rules include collateralized loan obligations, where the regulators have determined that the collateral manager should be considered the sponsor and be obligated to fulfill the risk retention requirement, and asset-backed commercial paper, where, despite liquidity arrangements and credit enhancement of underlying ABS held by the issuing conduit, an additional layer of risk retention generally will be required. For both collateralized loan obligations and asset-backed commercial paper, the specific exemptions included in the final rule are of very limited practical use.

It remains to be seen whether requiring sponsors of ABS transactions to maintain "skin in the game" through risk retention will result in improved asset quality in ABS pools, but sponsors and other participants should start preparing to meet the new requirements in the coming year.