Despite Challenges, Risk Retention Rules Set to Impact All Asset-Backed Securities by End of 2016

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Credit risk retention rules are intended to promote an alignment of interests between sponsors and investors of securitizations by requiring sponsors to maintain "skin in the game" — that is, retain a certain percentage of the credit risk of the securitized assets. On December 24, 2016, the rules, mandated by the Dodd-Frank Act, will become effective for all classes of asset-backed securities. Former Congressman Barney Frank, who co-sponsored the act, told *The New York Times* this requirement is the "single most important part of the bill." It is intended to be a fix for the flaws in the "originate-to-distribute" paradigm under which bad assets were originated and then sold into mortgage-backed securities transactions prior to the financial crisis. Yet the intended simple solution is a blunt instrument that is causing problems for certain types of asset-backed securities, including commercial mortgage-backed securities (CMBS) and collateralized loan obligations (CLOs), and some are mounting legal and legislative challenges to modify the rules.

The Basic Requirements

The rules apply to any sponsor of asset-backed securities and generally require the sponsor to retain a minimum of 5 percent of the fair value of all the securities and other asset-backed interests offered by the issuer. Asset-backed securities are defined as fixed-income securities collateralized by self-liquidating financial assets that allow holders of the securities to receive payments that depend primarily on the cash flow from the assets. This definition is broad enough to encompass some securities that may not have traditionally been considered asset-backed, but narrow enough to exclude certain types of securitization transactions, such as intellectual property securitizations, that rely on future revenue streams. It also would exclude loans made to a borrower that are secured by a pool of assets but where a security is not being issued to the lender.

Options for sponsors to meet these requirements include an "eligible horizontal residual interest" and an "eligible vertical interest." An eligible horizontal residual interest is the most subordinate claim with regard to payments of principal and interest. It should absorb any shortfalls in payments prior to any other interest. An eligible vertical interest is an equal interest in each class of securities issued in the securitization (*e.g.*, 5 percent of each class) or a single vertical security entitling the holder to a specific percentage of the amounts paid on each class of those securities. The retention requirement may be satisfied by a combination of a horizontal and vertical interest. An eligible horizontal cash reserve account held by a trustee in cash and cash equivalents also can be utilized.

The rules include special risk retention alternatives for revolving-pool securitizations, asset-backed commercial paper conduits, CMBS, government-sponsored enterprises, open market collateralized loan obligations and qualified tender option bonds. There also are exemptions for certain types of assets and transactions, most significantly an exemption for qualified residential mortgages (QRMs). The sponsor of a securitization with an asset pool comprised entirely of QRMs has no retention requirement. The market has generally concluded that most of the other exemptions for qualifying loans are not workable or sufficiently beneficial to be relied upon. For instance, the rules provide an exemption for qualifying automobile loans that may never be used because it requires loan characteristics, derived from the QRM definition, that are not common for auto loans.

For some standard classes of asset-backed securities, pre-existing forms of risk retention will suffice. For instance, a typical seller's interest retained by the depositor to a credit card securitization trust should satisfy the risk retention requirements for revolving pool securitizations, and subordinated securities retained by sponsors or affiliates in auto

loan securitizations should constitute eligible horizontal residual interests. In each case, sponsors will need to address new disclosure requirements.

For any horizontal interest, the sponsor must perform a fair value calculation in accordance with generally accepted accounting principles, and the sponsor's valuation method must be disclosed. The requirement to disclose this information, including the default and payment rate assumptions, may cause issuers who retain the most subordinated interests in their securitizations to rely on an eligible vertical interest despite the resulting reduction in advance rate on the collateral. The rules went into effect in December 2015 for residential mortgage-backed securities transactions, and for those issued with non-QRM assets, the preferred risk retention alternative has been an eligible vertical interest.

Litigation and Legislation

For some asset classes where the special risk retention options or asset exemptions are not of any real benefit and the burdens of risk retention will be commercially significant, industry groups are either pursuing litigation against the regulators who promulgated the rules or seeking legislative modifications to the rules.

The Loan Syndications and Trading Association (LSTA) sued the Federal Reserve and the Securities and Exchange Commission in November 2014, arguing that contrary to the position taken by the regulators, collateral managers for open market CLO transactions are not "securitizers" and therefore should not be obligated to retain the risk in CLOs. The LSTA also argued that the 5 percent requirement should be limited to the credit risk of the transaction and not be applied to the asset pool as a whole, and that the regulators should have considered a reasonable exemption or adjustment to the risk retention requirements for CLOs. For those reasons, the LSTA requested that the court vacate the risk retention rules insofar as they apply to open market CLOs. The LSTA commenced the lawsuit in the U.S. Court of Appeals for the District of Columbia Circuit. Following oral arguments, a decision was handed down on March 18, 2016, transferring the case to the U.S. District Court for the District of Columbia on the grounds that the appellate court lacks subject matter jurisdiction over agency actions.

The industry groups also are pushing for a legislative amendment to create an exemption for certain qualified CLOs that would reduce the retention requirement for collateral managers from 5 percent of all the ABS interests to 5 percent of the transaction's equity. Various structuring options, including the establishment of majority-owned affiliates of collateral managers with some third-party ownership and financing, are being considered to assist collateral managers who might otherwise not have sufficient capital to acquire and retain the required risk retention interest.

With respect to commercial real estate loans and CMBS, in March 2016, the House Financial Services Committee approved the Preserving Access to CRE Capital Act of 2016 to provide relief from risk retention requirements for CMBS transactions backed by a single commercial real estate loan or by a pool of qualified commercial real estate loans as redefined in the legislation.

While the litigation and legislation may not ultimately succeed in providing relief for CLOs and CMBS transactions, it demonstrates market participants' concerns regarding the potential adverse impact of implementation of the rules in their current form to those types of securitizations. The result may be a disruption in issuance in the CMBS markets, a reduction in the number of collateral managers continuing to operate in the CLO markets and a focused industry effort to bring other asset classes into compliance with the new rules by year-end.