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November 21, 2014 **REV.** December 24, 2014

To: Clients and Friends

From: Peter B. Idziak

Subject: Credit Risk Retention Final Rule

Our November 21, 2014 memorandum is hereby revised to reflect that the Agencies (as defined below) published the Final Rule in the December 24, 2014 Federal Register (79 FR 77602, click here)

On October 22, 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 ("SEC"), and, with respect to residential mortgage assets, the Federal Housing Finance Agency ("FHFA") and the Department of Housing and Urban Development, (collectively, the "Agencies") issued a joint final rule (the "Final Rule") that implements the credit risk retention requirements of section 15G of the Securities Exchange Act of 1934 (the "Exchange Act"), as added by section 941 of the Dodd-Frank Act, Public Law 111-203. The rule was initially proposed in April 2011, and re-proposed in September 2013 with significant modifications based on industry and public comments. The Final Rule largely tracks the language of the re-proposed rule, with the exception of the cash flow restrictions, which the Agencies did not adopt.

The Final Rule (i) requires a sponsor of asset-backed securities ("ABS") to retain a minimum of 5 percent of the credit risk of the assets collateralizing the asset-backed securities and (ii) prohibits the sponsor from directly or indirectly hedging or transferring that risk. The Final Rule includes a variety of exemptions from these requirements, including an exemption for asset-backed securities that are collateralized exclusively by "qualified residential mortgages" ("QRMs"). The definition of QRMs in the Final Rule is expressly aligned with the "qualified mortgage" ("QM") definition found in the Consumer Financial Protection Bureau's ("CFPB") Ability to Repay Rule. The Final Rule also exempts certain "community-focused residential mortgages" that are not eligible for QRM status because of the exemption they receive under the Ability to Repay Rule.

The Final Rule will become effective on December 24, 2015 for ABS collateralized exclusively by "residential mortgages"[1] and on December 24, 2016 for all other classes of ABS.

RISK RETENTION REQUIREMENT

Under the Final Rule, "sponsors" of ABS are required to retain a minimum of 5 percent of the credit risk of an ABS securitization. A "sponsor" is a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, into the ABS-issuing entity. In order to "organize and initiate" a transaction, the party must actively participate in the activities that impact the quality of the securitized assets underlying the transaction, which would typically involve underwriting and/or asset selection.

The Final Rule provides a "menu-based" approach that allows sponsors flexibility in choosing from a number of permissible forms of risk retention in order to meet the credit risk retention requirements. The option most likely to be utilized by sponsors, the "standard risk retention method", allows the sponsor to retain the required risk through either an eligible "vertical interest" or an eligible "horizontal residual interest", or any combination of the two, so long as the total amount of risk retained is at least 5 percent of the total value of the pool of securities.

The eligible "vertical interest" is a proportionate 5 percent interest in every class of the ABS interests issued in the securitization transaction (i.e., 5 percent of every tranche of the ABS). The sponsor can also hold this vertical interest through a single security that represents the principal and interest payments of each class of the ABS. The Final Rule does not require fair valuation calculations as the Agencies believe such calculations to be unnecessary.

The eligible "horizontal residual interest" is an amount equal to at least 5 percent of the fair value of all of the ABS interests in the security, and requires the sponsor to take a "first loss" position with respect to the asset pool. The fair value calculations must be determined in accordance with GAAP as of the closing date of the transaction.

Alternatively, a sponsor may establish a "horizontal cash reserve account." The amount of funds in the account must equal the amount of funds required if the sponsor held an eligible horizontal residual interest. The account is held by a trustee on behalf of the issuing entity and may be invested only in cash and cash equivalents (i.e., high-quality, highly-liquid short term investments). The sponsor can receive interest on the investments made in the account. The cash account funds must be used to satisfy payments due on the ABS if the issuing entity is unable to make such payments.

[1] As defined in the Final Rule, a "residential mortgage" is essentially any loan secured by a 1 to 4 unit residential property, whether such loan is a "covered transaction" under Regulation Z or not. Therefore, it includes home equity lines of credit, reverse mortgages, temporary loans, interests in timeshare plans, certain community-focused residential mortgages, and loans made for business purposes but secured by 1 to 4 unit residential property.

The Final Rule also lays out additional risk retention options for specific types of ABS transactions, such as revolving pool securitizations, asset-backed commercial paper conduits, commercial mortgage-backed securities, tender option bonds, open-market CLOs, and Fannie/Freddie issued ABS.

Allocation of Risk to Originators

A sponsor that elects the standard risk retention method discussed above may, with the consent of the originator, allocate up to the entire amount of the sponsor's required risk retention to that originator. An "originator" is defined as a person that creates a financial asset that collateralizes an ABS (i.e., a loan, lease, etc.), either through an extension of credit or otherwise. Only the original creditor of the asset is considered an originator for purposes of the Final Rule, so a sponsor may not allocate credit risk to an assignee or transferee of the original creditor.

Additionally, the Final Rule limits the transfer of credit risk to originators that have contributed at least 20 percent of the assets to the ABS pool, and requires the risk allocated to any qualifying originator to be at least 20 percent, but not in excess of the percentage of securitized assets it originated. The originator is required to hold its allocated share of the credit risk in the same manner as the sponsor, and subject to the same restrictions. However, the sponsor will remain responsible for compliance with the Final Rule, and must monitor compliance by each originator that has been allocated risk.

EXEMPTIONS FOR QUALIFIED RESIDENTIAL MORTGAGES, CERTAIN COMMUNITY-FOCUSED RESIDENTIAL LOANS, AND ABS ISSUED BY FANNIE MAE AND FREDDIE MAC

Qualified Residential Mortgage Exception

Section 15G of the Exchange Act contains an exemption from the credit risk retention requirements for ABS backed solely by residential mortgages that meet certain requirements (i.e., a QRM). In the original proposal, a QRM was defined as a residential mortgage securing a loan that had at least a 20 percent down payment, a front-end debt-to-income ratio of 28 percent and a back-end ratio of 36 percent. In response to public and industry comments, the Agencies modified the definition of QRM in the Final Rule to be co-extensive with the definition of QM found in the CFPB's Ability to Repay Rule. Now, under the Final Rule, any loan that meets the definition of QM (whether general or temporary) qualifies as a QRM.

In order for an ABS backed by QRMs to be exempt from the risk retention requirements of the Final Rule, the following conditions must be met:

- The pool of assets collateralizing the ABS must consist solely of QRMs;
- Each loan in the ABS pool must be currently performing (i.e., is not 30 days or more past due) as of the closing date of the securitized transaction; and

- The "depositor"[2] certifies that "it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the asset-backed security are qualified residential mortgages and has concluded that its internal supervisory controls are effective."

The "internal supervisory controls" evaluation must be performed for each issuance of ABS within 60 days of the cut-off date or similar date for establishing the composition of the asset pool collateralizing the ABS, and such certificate must be provided to potential investors within a reasonable time prior to the ABS sale, and upon request to the SEC and the appropriate regulator.

If, after closing of an ABS securitized by QRMs, it is discovered that a mortgage loan or loans in the asset pool did not meet all of the criteria to be a QRM, a sponsor may retain its credit risk exemption if all of the following conditions are satisfied:

- The depositor has completed the internal supervisory control certificate described above;
- The sponsor repurchases the non-QRM loan(s) at a price at least equal to the aggregate unpaid principal balance plus accrued interest within 90 days of determining the loan(s) are not compliant; and
- The sponsor promptly notifies the ABS holders of the noncompliance of the loan(s), the amount of the repurchase, and the cause for the repurchase.

Community-Focused Residential Mortgage Exemption

Because the Ability to Repay Rule exempted residential mortgage loans made by certain lenders—such as loans made by state housing finance authorities, other governmental entities, and certain non-profits—from the requirements of the Ability to Repay Rule, these loans do not qualify for QM status. As only QMs may qualify as QRMs under the Final Rule,[3] these community-focused residential loans cannot qualify as QRMs. However, recognizing that such loans: (i) have a history of strong underwriting of affordable mortgage credit; (ii) are subject to governmental oversight; and (iii) serve a public mission of increasing wealth to lower-income individuals, the Agencies have exempted such loans from the credit-risk retention requirements of the Final Rule.

Fannie Mae and Freddie Mac Exemption

[2] The Final Rule defines a "depositor" to be: (i) the person that receives or purchases and transfers or sells the securitized assets to the issuing entity; (ii) the sponsor, in the case of a securitization transaction where there is not an intermediate transfer of the assets from the sponsor to the issuing entity; or (iii) the person that receives or purchases and transfers or sells the securitized assets to the issuing entity in the case of a securitization transaction where the person transferring or selling the securitized assets directly to the issuing entity is itself a trust.

[3] Section 15G of the Exchange Act requires that the definition of QRM be "no broader" than the definition of QM found in the Ability to Repay Rule. This is why community-focused residential loans are not simply included as QRMs under the Final Rule, but are rather are given a separate exemption.

Finally, the Final Rule provides an exemption for mortgage-backed securities issued by Fannie Mae and Freddie Mac (or their successors) as long as they fully guarantee the timely payment of principal and interest on all ABS interests issued and operate under the conservatorship or receivership of FHFA with capital support from the United States. The Agencies believe that the full guarantee of timely payment of principal and interest made by Fannie and Freddie while they receive capital support from the United States provides a reasonable basis for concluding that such guarantees are consistent with the credit risk requirements of Section 15G of the Exchange Act. Fannie Mae and Freddie Mac will no longer qualify for the exemption if they cease being operated as a conservatorship or receivership by FHFA, cease receiving capital support from the United States, or are replaced by unlimited life regulated entities succeeding to their respective charters.

Future Exemptions

The Final Rule also authorizes the Agencies to provide additional exemptions at their discretion. Additionally, the Agencies are required to review both the QRM and the community-focused lending exemptions no later than four years after the effective date of the Final Rule with respect to residential mortgages, and every five years thereafter. The Agencies must also commence a review of the exemptions upon the request of any one of the Agencies.

The Final Rule, including the preamble, is almost 700 pages, and addresses credit risk requirements for several categories of ABS aside from QRMs. Obviously, the above summary is not a complete description of the Final Rule. For a full understanding we advise you to read the entirety of the Final Rule and preamble explanation by clicking on this hyperlink.