



Skin-in-the-Game: Perspectives on the Re-Proposed Risk Retention Rules

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Introduction

- On August 28, 2013, the SEC, FDIC, Federal Reserve, OCC, FHFA and HUD (the **Joint Regulators**) issued a second notice of proposed rule-making (the **Re-Proposed Rule**) in connection with the requirement under Section 941 of the Dodd-Frank Act that they jointly implement rules to:
 - (i) **require a sponsor** of most securitizations (including privately-placed issuances) **to retain at least 5% of the credit risk** related to that securitization; and
 - (ii) **restrict the transfer, hedging or pledge of the risk** that the sponsor is required to retain.
- The Joint Regulators prepared the Re-Proposed Rule in response to extensive comments received on the risk retention regulation that they initially proposed in April 2011 (the **Original Proposed Rule**).
- Comments on the Re-Proposed Rule are due on October 30, 2013.

Menu of Options

Consistent with the Original Proposed Rule, the Re-Proposed Rule provides a menu of options from which sponsors can choose to meet the risk retention requirements.

Standard Risk Retention Option	<ul style="list-style-type: none">▪ Eligible Vertical Interest▪ Eligible Horizontal Residual Interest or Horizontal Cash Reserve Account▪ Any combination of Eligible Vertical Interest and Eligible Horizontal Interest
Special Options	<ul style="list-style-type: none">▪ Revolving Master Trusts▪ Eligible ABCP Conduits▪ CMBS▪ Fannie Mae/Freddie Mac▪ Open Market CLOs▪ Tender Option Bonds

Exemptions and Qualifying Assets

Exemptions	Qualifying Assets
<ul style="list-style-type: none">▪ Transaction collateralized solely by qualified residential mortgages (QRMs);▪ Transaction is guaranteed by or consists solely of obligations of Federal government;▪ Transaction collateralized solely by residential, multifamily or health care facility mortgage assets guaranteed by Federal government;▪ Transaction collateralized solely by FFELP Loans that have 100% Federal guarantee;▪ State or municipal securitization;▪ Resecuritizations of ABS that satisfies specified conditions; or▪ Transaction sponsored by FDIC acting as receiver or conservator.	<ul style="list-style-type: none">▪ Re-Proposed Rule defines “qualifying” commercial, mortgages, commercial loans and automobile loans, based on underwriting standards intended to incorporate features and requirements historically associated with very low credit risk in these asset classes.▪ If transaction collateralized solely by qualifying assets, sponsor’s risk retention requirement is 0%.▪ Otherwise, sponsor’s risk retention requirement is reduced by ratio of unpaid principal of qualifying assets in the securitized pool to the total unpaid principal balance of all assets in the securitized pool.

Transfers and Hedges

- Sponsors are **prohibited from selling or hedging** their related credit risk.
- Under the Re-Proposed Rule's **sunset provisions**, the prohibitions on sale and hedging for **non-RMBS** transactions exposure on the latest of:
 - (a) 2 years after the closing date of the securitization transaction;
 - (b) the date on which the principal balance of the securitized assets has been reduced to **33% of the original principal balance**; and
 - (c) the date on which the principal obligations under the ABS interests have been reduced to **33% of the original principal obligations**.
- Permissible Allocation of Risk to Originator of at least 20% of pool.

Disclosures

Detailed disclosure requirements are provided for each form of risk retention. However, the core elements of the disclosure requirements are:

- Value of interest the sponsor will retain at closing;
- Value of the interest that the sponsor is required to retain;
- Material terms of the retained interest retained;
- Methodology used to calculate the value;
- Key inputs and assumptions used in measuring value;
- Reference data set or other historical information used to develop the key inputs and assumptions; and
- The historical performance of retained interests held by sponsor in connection with other securitization transactions.

Effective Date

- Two Years following publication of Final Rule in Federal Register for non-RMBS.
- One Year following publication of Final Rule in Federal Register for RMBS.

Deeper Dive: Standard Risk Retention



Standard Risk Retention

Horizontal	<p>The sponsor holds 5% of the fair value of the first-loss tranche of the ABS interests issued by the issuing entity. This obligation may be satisfied in whole or in part by the use of a fully funded reserve account held by a trustee.</p> <ul style="list-style-type: none">• Horizontal interest may not be structured to amortize more quickly than issued ABS.
Vertical	<p>The sponsor may hold 5% of the fair value of each class of ABS interests issued by the issuing entity. The vertical interest may be held in the form of multiple securities or in the form of a single security.</p>
Combination	<p>The sponsor may hold horizontal interests and vertical interests in any proportion as long as the total risk retention is at least equal to 5% of the fair value of the issued ABS interests.</p>

Fair Value

- The “**fair value**” of the amount retained by the sponsor must equal at least 5% of the fair value of all ABS interests issued in the securitization, determined in accordance with GAAP.
- Fair value is determined as of the day on which the price of the ABS interests sold to 3rd parties is determined.

Deeper Dive: Revolving Master Trusts



Revolving Master Trusts – Seller’s Interest Option

A sponsor satisfies the risk retention requirement with respect to a revolving master trust if the sponsor retains a seller’s interest of not less than 5% of the unpaid principal balance of all outstanding investors’ ABS interests issued by the issuing entity.

“Seller’s Interest” means an ABS interest or ABS interests:

- (a) Collateralized by all of the securitized assets (other than assets that have been allocated as collateral only for a specific series);
- (b) That is pari passu to each series of investors’ ABS interests issued by the issuing entity with respect to allocation of all distributions and losses with respect to the securitized assets prior to an early amortization event; and
- (c) That adjusts for fluctuations in the outstanding principal balance of the securitized assets in the pool.

Measuring and Retaining Seller's Interest

- To satisfy the special option for revolving master trusts, the seller's interest must meet the 5% test **at the closing of each issuance** of ABS interests by the issuing entity and at every **seller's interest measurement date** specified under the securitization documents (but no less than monthly).
- The seller's interest would be measured on a face-value basis (rather than fair-value basis), so long as the master trust does not issue senior interest-only bonds or premium bonds.
- Regulators are considering the treatment of **"subordinated" seller's interests** (whether they should count toward the 5% seller's interest requirement on a face-value vs. fair-value basis).
- The seller's interest **may be retained by one or more wholly-owned affiliates** of the sponsor, including one or more depositors of the revolving master trust.

Combining Seller's Interest with Horizontal Risk Retention

The sponsor may combine the seller's interest with either of two horizontal types of risk retention held at the series level:

- Retention of an **eligible horizontal residual interest in every series** issued by the master trust, in a form meeting the same criteria as apply under the standard risk retention requirement; or
- Retention of a **horizontal interest in the excess spread of every series**.

These forms of horizontal risk retention would be measured on a fair-value basis and the sponsor would be able to reduce its seller's interest by a corresponding amount.

Treatment of Series Trusts & Legacy Trust Structures

- The seller's interest option is available to revolving master trusts, but not to **"series trusts."**
- In the case of **legacy trust structures**, the seller's interest may represent multiple interests in the issuance platform, but the portion of the seller's interest held through the legacy trust must be proportional to the percentage of assets that the collateral certificate(s) comprise of the issuing trust's assets.

Other Provisions of Seller's Interest Option

Excess Funding Account	The required seller's interest may be reduced by the balance of a segregated excess funding account , subject to conditions, including that the EFA absorb its allocable share of losses.
Early Amortization Event	The sponsor of a revolving master trust will not violate the rule if the seller's interest falls below the required level following a trust-wide early amortization event , subject to conditions, including that the sponsor was in compliance at all times before the early amortization event.
No grandfathering	The sponsor must comply with the rule beginning with the master trust's first issuance after the effective date of the final rule, but the 5% test will be measured in relation to the entire unpaid principal balance of the master trust's outstanding investors' ABS interests, regardless of whether those interests were issued before or after the effective date of the final rule.

Deeper Dive: ABCP Conduits



Application of Re-Proposed Rule to ABCP Arrangers

- The risk retention requirement applies to the “**sponsor**” of a securitization. This term is defined to include any person who “organizes and initiates a securitization transaction by **selling or transferring assets**... to the issuing entity.”
- Banks or investment managers (“**arrangers**”) who organize and manage ABCP conduits, but who don’t themselves transfer any assets to the ABCP conduits, do not fall within the definition of “sponsor.”
- However, the Joint Regulators appear to intend to impose the Re-Proposed Rule’s risk retention requirements on arrangers of ABCP conduits.

Compliance by ABCP Arrangers

Assuming that ABCP arrangers are subject to the risk retention requirement, they have 2 options for compliance:

- (1) Retain credit risk in the form of a **Standard Risk Retention**; or
- (2) Invoke **Safe Harbor** for Eligible ABCP conduits (which eliminates need for arranger to retain risk).

Safe Harbor for Eligible ABCP Conduits

The Safe Harbor for Eligible ABCP Conduits will impose significant operating restrictions on conduits that use it. Certain conduits simply won't qualify for the Safe Harbor.

Safe Harbor for Eligible ABCP Conduits

To satisfy the safe harbor for an eligible ABCP conduit, an arranger must satisfy the following key provisions:

1. All ABCP must be supported by an **unconditional liquidity commitment** from an eligible liquidity provider.
2. All liquidity support must be provided by a **single liquidity provider**.
3. All ABCP must have **term of 270** days or less.

Safe Harbor for Eligible ABCP Conduits

(Continued)

4. Assets it may acquire are ABS collateralized solely by:
 - ABS collateralized solely by assets originated by an **originator-seller** or one or more **majority-owned OS affiliates** and servicing assets;
 - **SUBIs** and other similar trust or SPV interest where the trust or SPV receives legal title to the leased property underlying leases that were transferred to an intermediate SPV in connection with a securitization collateralized **solely by such leases and servicing assets**.
 - Interests in **revolving master trusts** collateralized solely by assets originated by an originator-seller or majority-owned OS affiliate and servicing assets.
5. Conduit may not purchase corporate debt securities, government securities, equity securities or ABS collateralized by assets originated by two or more unaffiliated originators and may not directly make loans or purchase receivables.
6. Arranger must approve each originator-seller and perform other specified duties.

Safe Harbor for Eligible ABCP Conduits

(Continued)

7. Arranger must disclose to each ABCP investor (no later than the first sale of ABCP to such investor and at least monthly thereafter):
 - Name and form of organization of regulated liquidity provider;
 - Form, amount and nature of liquidity coverage;
 - Notice of any failure by the liquidity provider to fund;
 - Asset class or brief description of underlying receivables;
 - SIC code of each originator-seller; and
 - Description of form, fair value and nature of the retained interest.
8. Arranger must monitor originator-seller's compliance with its risk retention requirement.

Safe Harbor for Eligible ABCP Conduits

- If the Arranger determines that any Originator-Seller has not complied with the risk retention requirement, or has impermissibly hedged its risk position, the Arranger must promptly notify the ABCP holders, the SEC and its federal banking regulator of the name of such Originator-Seller and the amount of related ABS held by the conduit.
- Except as stated, the Arranger does not need to disclose the names of the Originator-Sellers to investors (this is a change from the Original Proposed Rule).

Safe Harbor for Eligible ABCP Conduits

The foregoing restrictions effectively mean that the safe harbor is available only for “traditional” single seller or multiseller conduits that comply with its operating restrictions and cannot be used by “repo conduits” or similar vehicles that finance non-ABS securities and/or rely upon liquidity and credit support provided by multiple unaffiliated support providers.

Deeper Dive: Auto Loan and Lease ABS



Auto Loan and Lease ABS

Exception for Qualifying Automobile Loans:

Underwriting requirements:

- Verification of borrower debt to income ratio required;
- Down payment of 10% + dealer fees, tax, title, registration; and
- Obtain credit report.

Auto lenders reporting that no existing loans would qualify under exception.

Concerns with standard risk retention:

- Defects in original NPR regarding requirement that horizontal interest be allocated losses and limitation of principal distributions to proportionate share of scheduled principal payments was corrected to take into account single waterfall structures.
- Issue with disclosure.
 - Disclosure of reference data and historical information for required cash flow projections is often proprietary and lenders will be sensitive to disclosing

Deeper Dive: Open Market CLO



CLOs

- Regulators consider **collateral manager to be sponsor** of open market CLOs, required to retain risk retention, because manager selects loans and manages asset pool.
 - Manager doesn't typically transfer assets to the Issuer, which is one of the prongs of definition of sponsor. Regulators rely on discretion given regulators under the statute to impose expansive definition of sponsor for CLOs.
 - Typical CLO does not have manager holding significant stake in deal. Requirement that CLO managers put up capital to fund 5% risk retention will drive many managers from the market, and may drastically reduce the CLO market.

CLOs: Special Exception for Syndicated Senior Secured Lending Facilities

Each ABS in CLO must be a CLO-Eligible Loan Tranche:

- Senior, secured syndicated commercial loans.
- Lead arranger of each loan in CLO must retain and hold 5% of loan facility.
- Lead arranger must also initially take an allocation of at least 20% of loan facility, with no other lender taking a larger amount.
- Credit agreement must include representation of lead arranger that it and the tranche meets the requirements of the risk retention rule.
- Certification of collateral manager as to adequacy of loan collateral and borrower attributes in regular periodic disclosures to investors.

As a practical matter, no banks are likely to agree to these requirements.

Deeper Dive: FFELP Student Loans



FFELP Student Loans

The Re-Proposed Rule provides relief to the general 5% risk retention requirement to sponsors of FFELP student loan ABS transactions.

Amount of Federal Guarantee	Type of FFELP Loan	Sponsor's Risk Retention Requirement
100%	1 st disbursement prior to October 1993 <u>or</u> full guarantee otherwise required	0%
98%	1 st disbursement between October 1993 and June 2006	2%
97%	All other FFELP loans	3%

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