



Final Credit Risk Retention Rule

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Introduction

- In October 2014, the SEC, FDIC, Federal Reserve, OCC, FHFA and HUD (the **Joint Regulators**) adopted a final rule (the **Final Rule**) implementing the requirements of Section 15G of the Exchange Act.
- Section 15G (which was added pursuant to Section 941 of the Dodd-Frank Act) required the Joint Regulators to prescribe regulations to:
 - (i) **require any securitizer** of asset-backed securities (ABS) **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 initially proposed the credit risk retention rule in April 2011 and, in response to extensive comments, re-proposed the rule in August 2013 pursuant to a second joint notice of proposed rulemaking (the **Re-Proposed Rule**). The Final Rule retains the framework of the Re-Proposed Rule.
- The Final Rule will be effective for all asset classes other than RMBS **two years following publication of the Final Rule in the Federal Register**.

FFELP Student Loans

The Final 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%

Menu of Options

Unless an exemption under the Final Rule applies, sponsors of securitizations that issue ABS interests must retain risk in accordance with a standardized risk retention option or in accordance with one of the special risk retention options available for specific types of asset classes.

Standard Risk Retention Options	<ul style="list-style-type: none">▪ Eligible Vertical Interest▪ Eligible Horizontal Residual Interest (including an Eligible Horizontal Cash Reserve Account)▪ Any combination of Eligible Vertical Interests and Eligible Horizontal Residual Interests
Special Options	<ul style="list-style-type: none">▪ Revolving Pool Securitizations (i.e., master trusts)▪ Eligible ABCP Conduits▪ CMBS▪ Fannie Mae/Freddie Mac▪ Open Market CLOs▪ Qualified Tender Option Bonds

Exemptions and Qualifying Assets

Exemptions	Qualifying Assets
<ul style="list-style-type: none">▪ Transaction collateralized solely by qualified residential mortgages (QRMs) or servicing assets;▪ 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">▪ Final Rule defines “qualifying” commercial loans, commercial real estate 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.

Standard Risk Retention: Overview

- The percentage of the eligible vertical interest, eligible horizontal residual interest, or combination thereof retained by the sponsor must **be determined as of the closing date** of the securitization transaction.
- A sponsor relying on a standard risk retention option must provide, or cause to be provided, to potential investors, under the caption “Credit Risk Retention”, a reasonable period of time prior to the sale of the ABS in the securitization transaction specified **disclosures** in written form and within specified time frames.
- A sponsor must **retain** the required certifications and disclosures in its records and must provide the disclosure upon request to the SEC (and its appropriate federal banking agency, if any) until 3 years after all ABS interests are no longer outstanding.

Standard Risk Retention: Eligible Vertical Interest

If the sponsor chooses to satisfy its risk retention requirement solely through an eligible vertical interest, the amount of the interest retained by the sponsor must equal not less than 5%.

An eligible vertical interest can be either:

- **a single vertical security** (i.e., an ABS interest entitling the sponsor to a specified percentage of the amounts paid on each other class of ABS interests in the issuing entity); or
- **an interest in each class** of ABS interests issued as part of the securitization transaction

Evaluate all ABS interests regardless of whether the class of interests has a face or par value, was issued in certificated form or was sold to unaffiliated investors.

If a class of interests has no face value, the sponsor is required to hold an interest in 5% of the cash flows paid on that class.

Standard Risk Retention: Eligible Horizontal Residual Interest

If the sponsor chooses to satisfy its risk retention obligation solely through an eligible horizontal residual interest (**EHRI**), the amount of the interest retained by the sponsor must equal **at least 5% of the fair value of all ABS interests in the issuing entity**.

An eligible horizontal residual interest:

- is an ABS interest in the issuing entity
- may be an interest in a single class or multiple classes
- has the most subordinated claim to payments of both principal and interest
- any shortfalls must reduce the EHRI prior to any reduction in the amounts payable to any other ABS interest (whether through loss allocation, operation of the priority of payments, or other governing contractual provision (until the amount of such ABS interest is reduced to zero))

Standard Risk Retention: Eligible Horizontal Cash Reserve Account

In lieu of retaining an EHRI, the sponsor may establish and fund, in cash, at closing, an **eligible horizontal cash reserve account** in the same amount that would be required if the sponsor held an eligible horizontal residual interest, provided that the account meets certain conditions.

An eligible horizontal cash reserve account must meet the following conditions:

- The account is held by the trustee (or a person performing similar functions) in the name and for the benefit of the issuing entity
- Amounts in the account are invested only in cash and cash equivalents
- Until all ABS interests in the issuing entity are paid in full or the issuing entity is dissolved:
 - Amounts in the account shall only be released to (1) satisfy payments on the ABS interests on any payment date on which the issuing entity has insufficient funds to satisfy an amount due on any ABS interest and (2) pay critical expenses of the trust unrelated to credit risk on any payment date on which the issuing entity has insufficient funds to pay such expenses and (a) such expenses would otherwise be paid prior to any payments to the holders of the ABS and (b) such payments are made to parties that are not affiliated with the sponsor
 - Interest (or other earnings) on investments may be released once received by the account

Standard Risk Retention: Disclosure Regarding Horizontal Interests

A reasonable period of time prior to the sale of an ABS, a sponsor must disclose:

- **Fair value of the EHRI** the sponsor expects to retain at closing
 - Fair value is to be expressed as (a) a percentage of the fair value of all ABS interests issued in the transaction and (b) a dollar amount.
 - If the specific price, size or rate of interest for each tranche is not available, the sponsor must disclose (1) a range of fair value of the EHRI that the sponsor expects to retain at closing based on a range of *bona fide* estimates or specified prices, sizes or ranges for each tranche of the securitization; and (2) the method by which the sponsor made such determination.
- **Material terms of the EHRI** to be retained
- **Valuation methodology** used to calculate fair value
- **Key inputs and assumptions** used in measuring estimated total fair value, including (1) specified quantitative information about the valuation methodology and (2) a summary of the description of the reference data or other historical information used to develop the key inputs and assumptions
- All inputs and assumptions that either could have a **material impact on the fair value calculation** or would be **material to a prospective investor's ability to evaluate the sponsor's fair value calculations**

Standard Risk Retention: Disclosure Regarding Horizontal Interests

A reasonable period after the closing of the securitization transaction, a sponsor must disclose:

- Fair value of the EHRI the sponsor retained at closing, based on actual sale prices and finalized tranche sizes
- Fair value of the EHRI that the sponsor is required to retain
- Description of the material differences, if any, between the valuation methodology and any of the key inputs and assumptions that were used in calculating the fair value or range of fair values disclosed prior to the sale and the methodology or key inputs and assumptions used to calculate the fair value at the time of closing

If the sponsor retains risk through funding an eligible horizontal cash reserve account, it must disclose:

- The amount to be placed in the eligible horizontal cash reserve account at closing and the fair value of the EHRI that the sponsor is required to fund through the eligible horizontal cash reserve account in order for the account (together with other retained interests) to satisfy the sponsor's risk retention requirement
- A description of the material terms of the eligible horizontal cash reserve account
- The other disclosures required with respect to EHRIs before and after closing

Standard Risk Retention: Fair Value Calculation

- The Final Rule requires that an EHRI be measured at fair value, using **a fair value measurement framework under GAAP**. Under the Final Rule, a fair value calculation is not necessary for vertical retention.
- To the extent a sponsor uses a valuation methodology that calculates fair value based on the pool of securitized assets as of a certain date, a sponsor may use **a cut-off date** or similar date for establishing the composition and characteristics of the pool of securitized assets that is **not more than 60 days** prior to the date of first use of the fair value calculation with investors.
- In the case of a securitization transaction that makes distributions to investors on a **quarterly or less frequent basis**, however, the sponsor may use a cut-off date or similar date **not more than 135 days** prior to the date of first use of the fair value calculation with investors.
- The methodology **may include anticipated additions to or removals of assets** that the sponsor will make between the cut-off date and the closing date.

Standard Risk Retention: Combination of Vertical & Horizontal

If the sponsor retains both an eligible vertical interest and an EHRI (including an eligible horizontal cash reserve account) as its required risk retention, the combined percentage of the fair value of the eligible horizontal residual interest and the percentage of the eligible vertical interest must equal at least 5%.

Allocation of Risk to Originator

A sponsor may allocate a portion of its retained credit risk to the originator of the securitized assets if (among other things):

- The originator originated at least 20% of the underlying assets in the pool
- Each originator is limited to holding no more than its proportional share of the risk retention obligation
- The sponsor may not make this allocation to an originator if such originator merely acquires loans and then transfers them to the sponsor

The originator and each of its affiliates must comply with the hedging and other restrictions as if it was required to retain the interest by the rule.

The retaining sponsor will be responsible for compliance and shall:

- Maintain and adhere to policies and procedures that are reasonably designed to monitor the compliance by each originator that is allocated a portion of the sponsor's risk retention obligations with the Rule's requirements; and
- In the event that the sponsor determines that an originator no longer complies with the Rule's requirements, the sponsor shall promptly notify (or cause to be notified) the holders of the ABS of such noncompliance.

Transfers and Hedges

The Final Rule generally prohibits a sponsor or any affiliate from hedging to transferring the credit risk that the sponsor is required to retain.

Transfer: A retaining sponsor may not sell or otherwise transfer any interest or assets that the sponsor is required to retain to any person other than a majority-owned affiliate and each such majority-owned affiliate shall be subject to the same restrictions.

Prohibited Hedging by Sponsor and Affiliates: A retaining sponsor and its affiliates may not purchase or sell a security, or other financial instrument, or enter into an agreement, derivative or other position, with any other person if:

- Payments on the security or other financial instrument or under the agreement, derivative or position are materially related to the credit risk of one or more particular ABS interests that the retaining sponsor (or its majority-owned affiliates) is required to retain with respect to a securitization transaction or one or more of the particular securitized assets that collateralize the ABS;
- The security, instrument, agreement, derivative or position in any way reduces or limits the financial exposure of the sponsor (or any of its majority-owned affiliates) to the credit risk of one or more of the particular ABS interests that the retaining sponsor (or any of its majority-owned affiliates) is required to retain.

Transfers and Hedges (continued)

Prohibited Hedging by Issuing Entity: The issuing entity may not purchase or sell a security or other financial instrument, or enter into an agreement, derivative or position, with any other person if:

- Payments on the security or other financial instrument or under the agreement, derivative or position are materially related to the credit risk of one or more particular ABS interests that the retaining sponsor for the transaction (or any of its majority-owned affiliates) is required to retain; and
- The security, instrument, agreement, derivative, or position in any way reduces or limits the financial exposure of the retaining sponsor (or any of its majority-owned affiliates) to the credit risk of one or more of the particular ABS interests that the sponsor (or any of its majority-owned affiliates) is required to retain.

Prohibited Non-Recourse Financing: Neither a retaining sponsor nor any of its affiliates may pledge as collateral for any obligation (including a loan, repurchase agreement or other financing transaction) any ABS interest that the sponsor is required to retain unless such obligation is with full recourse to the sponsor or affiliates, respectively.

Transfers and Hedges (continued)

Permitted Hedging Activities

- Hedging the interest rate risk (which does not include the specific interest rate risk, known as spread risk, associated with the ABS interests that is otherwise considered part of the credit risk) or foreign exchange risk arising from one or more of the particular ABS interests required to be retained by the sponsor (or any of its majority-owned affiliates) or one or more of the particular securitized assets that underlie the ABS issued in the securitization transaction
- Purchasing or selling a security or other financial instrument or entering into an agreement, derivative, or other position with any third party where payments on the security or other financial instrument or under the agreement, derivative or position are based, directly or indirectly, on an index of instruments that includes ABS if:
 - Any class of ABS interests in the issuing entity that were issued in connection with the securitization transaction and that are included in the index represents no more than 10% of the dollar-weighted average of all instruments included in the index; and
 - All classes of ABS interests in all issuing entities that were issued in connection with any securitization transaction in which the sponsor (or any of its majority-owned affiliates) is required to retain an interest and that are included in the index represent, in the aggregate, no more than 20% of the dollar-weighted average of all instruments included in the index.

Transfers and Hedges (continued)

Duration of Hedging and Transfer Restrictions

For all non-RMBS transactions, the prohibitions on sale and hedging expire on or after the date that is the last of:

- The date on which **the total unpaid principal balance of the securitized assets** that collateralize the securitization transaction has been **reduced to 33%** of the total unpaid principal balance of the securitized assets as of the cut-off date of the securitization transaction;
- The date on which the **total unpaid principal obligations under the ABS interests** issued in the securitization transaction has been reduced to 33% of the total unpaid principal obligations of the ABS interests at closing of the securitization transaction; or
- **Two years after the closing date** of the securitization.

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