



U.S. Regulators Finalize Credit Risk Retention Rules

Today, the Federal Deposit Insurance Corporation (the “FDIC”), the Federal Housing Finance Agency (the “FHFA”), and the Office of the Comptroller of the Currency (the “OCC”) each adopted a final rule (the “Final Rule”) implementing the credit risk retention requirements of section 941 of the Dodd-Frank Act for asset-backed securities (“ABS”). The Federal Reserve Board, the Securities and Exchange Commission, and the Department of Housing and Urban Development (together with the FDIC, FHFA, and OCC, the “Joint Regulators”) are expected to adopt the Final Rule tomorrow. The risk retention rules were initially proposed by the Joint Regulators in March 2011 and re-proposed in August 2013 (the “Re-Proposal”). The Final Rule will become effective one year from the date of publication in the Federal Register for residential mortgage-backed securities (“RMBS”) and two years from the date of publication in the Federal Register for all other ABS.

As required by the Dodd-Frank Act, the Final Rule generally requires securitizers in both public and private securitization transactions to retain not less than 5% of the credit risk of the assets collateralizing any ABS issuance.

The Final Rule generally tracks the requirements of the Re-Proposal with minor changes made to address comments submitted or to clarify meaning. Following are some of the key provisions of the Final Rule adopted by the FDIC, FHFA, and OCC today:

- The Final Rule generally permits risk retention to be accomplished through one or a combination of methods: a vertical interest, a horizontal interest, or some combination of both (an “L-shaped interest”). The percentage of the vertical, horizontal, or L-shaped interest to be retained by the sponsor must be determined as of the closing date of the transaction. Horizontal risk retention may be accomplished by holding ABS issued in the transaction or by establishing a cash reserve account for the transaction.
- There are also transaction-specific risk retention options for revolving securitization pools, asset-backed commercial paper conduits, commercial MBS (“CMBS”), and Fannie Mae and Freddie Mac MBS.
- The Final Rule exempts certain types of securitizations from risk retention requirements, including government-guaranteed securitizations and qualifying “pass-through” resecuritizations.
- Also exempt are securitizations backed by auto loans, commercial loans, and commercial real estate loans that meet specified underwriting standards, as well as qualified residential mortgage loans, or “QRMs.”
- There is no minimum down payment requirement for QRMs. The Final Rule’s definition of QRM is the

same as the definition of “qualified mortgage,” or “QM,” under the Consumer Financial Protection Bureau’s (the “CFPB”) “ability-to-repay” rules. The Joint Regulators must review the QM definition four years from the effective date of the Final Rule and every five years thereafter, or at any time upon request by one of the Joint Regulators, and determine if the QM definition at such time is still the appropriate definition to use to define QRM.

- Consistent with the CFPB’s “ability-to-repay” rules, there are also exemptions from risk retention for certain community-focused residential mortgage loans and certain 3-to-4 unit residential mortgage loans.
- Securitizers of RMBS will not be allowed to reduce their risk retention requirements by commingling QRM and non-QRM loans in a single securitization. However, securitizers of commercial, commercial real estate, or auto loans will be able to reduce their risk retention requirement by up to 50% (that is, to 2.5%) using such “blended pools.”
- The Final Rule includes a transaction-specific risk retention option for certain open-market collateralized loan obligations (“CLOs”) that would permit lead arrangers of loans held by the CLO to retain the 5% risk, rather than the CLO manager.
- As in the Re-Proposal, CMBS issuers will have the option of satisfying risk retention requirements by transferring up to two *pari passu* subordinated horizontal interests, or “B-pieces,” to third-party purchasers.
- The restrictions on securitizers hedging or transferring retained interests for specified periods after the securitization remain unchanged from the Re-Proposal:
 - For RMBS transactions, the restrictions would expire on or after the date that is (1) the later of (a) five years after the closing date or (b) the date on which the total unpaid principal balance of the securitized assets is reduced to 25 percent of the original unpaid principal balance as of the closing date, but (2) in any event no later than seven years after the closing date.
 - For all other ABS transactions, the restrictions would 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 that collateralize the securitization are reduced to 33 percent of the original unpaid principal balance as of the closing date, (2) the date on which the total unpaid principal obligations under the ABS interests issued in the securitization is reduced to 33 percent of the original unpaid principal obligations as of the closing date, or (3) two years after the closing date.
- The Final Rule includes a limited safe harbor excluding from the risk retention requirements certain predominantly foreign securitizations. The safe harbor requires, among other conditions, that no more than 10% of the value of all classes of ABS be sold or transferred to or for the account of U.S. persons.

Although the Final Rule is substantially the same as the Re-Proposal, there are a few notable differences. The following significant changes from the Re-Proposal are included in the Final Rule adopted today:

- As noted above, there is no minimum down payment requirement for QRMs, settling one of the most contentious debates surrounding risk retention.
- The 5% risk retention requirement will be measured based on the “fair value” of securitization interests retained for horizontal risk retention, but at par value of securitization interests retained for vertical risk retention. The different valuation methods must be used even when retaining a combination of the two risk retention methods.

- The Final Rule does not include restrictions on cash flow payments to the holders of the horizontal residual interest that were contained in the Re-Proposal.
- If horizontal risk retention is used, certain additional disclosures relating to asset valuation, assumptions, inputs, and methodology must be provided to investors prior to the ABS offering with additional fair value methodology disclosures to be provided upon completion of the offering.

A more detailed client alert regarding the Final Rule will be issued upon further analysis of the Final Rule and accompanying adopting release.

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