Client Alert

September 2016

Risk Retention Rules Effective For All Asset-Backed Securities December 24, 2016

I. Overview of Risk Retention Rules

The risk retention rules enacted under the Dodd-Frank Act (the "Rules") went into effect for all non-exempt RMBS securitizations on December 24, 2015, and will be applicable to all other non-exempt asset-backed securities (as defined under the Securities Exchange Act of 1934) ("ABS"), including revolving pool securitizations, on December 24, 2016. As described in the Hunton & Williams LLP client alert "Reminder—Compliance Date for RMBS Risk Retention Rules is Right Around the Corner", dated December 2015, there are two standard forms of risk retention permitted by the Rules, (i) eligible horizontal residual interest ("Horizontal Interest") and (ii) eligible vertical residual interest ("Vertical Interest") (or a combination of Horizontal Interest and Vertical Interest). In addition to the standard forms of risk retention, there is a form unique to revolving pool securitizations that is the Seller's Interest (as described below).

This client alert will explore in detail why the Seller's Interest may be the preferred form of risk retention for servicer advance facilities organized as master trusts.

II. How Servicer Advance Facilities Work

Generally, servicer advance facilities ("SAFs") provide financing to servicers for their contractual rights to reimbursements for advances and expenses paid by the servicers, as well as their right to receive repayment for deferred servicing fees (collectively, "SARs"). In most instances, SARs are reimbursed prior to RMBS or whole-loan investors out of collections or proceeds from the related underlying mortgage loan, and, in most cases with respect to advances, if not recoverable from the related mortgage loan, they are reimbursed from general collections of the entire loan pool.

The typical master trust structure provides that all SARs from a designated population of servicing agreements are transferred to a bankruptcy remote special purpose vehicle depositor, which is a wholly-owned subsidiary of the sponsor (often, but not always, the servicer). The depositor then sells or contributes the SARs to a Delaware statutory trust, which in turn issues one or more series of revolving notes ("VFNs") and/or term notes. During the revolving period, the transfers from the Servicer to the Depositor to the Issuer happen on a continual basis and are purchased by using reimbursements of existing servicer advances (net of expenses, including payments on the notes) and draws on the VFNs. Under the typical master trust structure, multiple series of notes may be outstanding at a time and may be issued at different times (subject to tax restrictions and satisfaction of conditions precedent in the transaction documents), but all notes are backed by the entire pool of SARs.

Credit enhancement in SAFs is typically in the form of over-collateralization, and each series may require different levels. The over-collateralization is usually equity in the issuer and is subordinated to all notes issued by the issuer ("Issuer's Equity Interest"). Over-collateralization for each series is sized by multiplying the advance rates for the various types of SARs against the par value of the applicable SARs.

In addition, most facilities are structured to include performance tests to protect investors should the recovery rates decline (or interest rates spike) relative to the assumptions used to determine advance rates. Prior to the end of the revolving period and the beginning of the amortization period, the Issuer's Equity Interest must be equal to or greater than the required level of over-collateralization. Most deals include limitations on financing the Issuer's Equity Interest for tax structuring purposes, as well as to address EU risk retention requirements, if applicable.

III. Seller's Interest as Preferred Form of Risk Retention for SAFs

A. Determination of Seller's Interest and Requirements for Compliance Under the Rules

A revolving pool securitization may use the Seller's Interest form of risk retention to satisfy the Rules as an alternate to the standard forms of risk retention. The final Rules, as adopted, provide that the Seller's Interest may be either (i) *pari passu* with each series of investor ABS interests or (ii) partially or fully subordinated to one or more series in identical or varying amounts with respect to the allocations and losses on the securitized assets. The Seller's Interest must adjust for fluctuations in the outstanding principal balance of the assets in the pool and be maintained at 5 percent (the "5 percent test") and cannot take into account ineligible assets or assets that are allocated as collateral only for specific series. The Seller's Interest must be retained by the sponsor (or one or more wholly-owned affiliates including the depositor), and is not allowed to be held by majority-owned affiliates.

The Seller's Interest is calculated with the numerator as (i) the unpaid principal balance of all securitized assets (excluding ineligible assets and collateral allocated to a specific series, such as interest reserve accounts), minus (ii) the unpaid principal balance of all investor ABS interests sold to investors and the denominator as the unpaid principal balance of all investor ABS interest sold to investors (subject to the offsets described below).

The 5 percent test must be determined and satisfied at the closing of each issuance of ABS interests to investors by the Issuer, and in any event at least monthly under a date specified by the SAF (the "Monthly Compliance Date"), until no ABS interests in the Issuer are held by any person or business entity that is not a wholly-owned affiliate of the sponsor. If the sponsor fails to meet the 5 percent test by the Monthly Compliance Date, but the SAF allows for a cure period, then the 5 percent test must be determined and satisfied by the earlier of (i) the cure period or (ii) one month after the Monthly Compliance Date. Alternatively, in the event of early amortization — when the sponsor was in full compliance before amortization — the sponsor may still satisfy the Rules if the Seller's Interest is *pari passu* with or subordinate to each series of ABS interest issued, and if the terms of any horizontal interest offset, if any, require the interests to absorb losses as subordinate interests.

Potential offsets exist in the determination of outstanding ABS interests issued to investors for purposes of calculating the Seller's Interest. Specifically, the amount of ABS interest held by the sponsor, or its wholly-owned affiliate, will not be considered in the determination of "all outstanding ABS interests" when calculating the Seller's Interest — but only if the ABS interests are retained indefinitely, and not sold to a third-party. In addition, the aggregate unpaid principal balance of outstanding ABS interests held by investors may be reduced by the amount of funds held in a segregated principal accumulation account that (i) can only be applied for repayment of the ABS interests and (ii) are invested only in permitted investments for eligible horizontal cash reserve accounts.

Potential offsets exist for the Seller's Interest itself, as well, such as a pool-level excess funding account, a residual ABS interest in excess interest and fees, and a Horizontal Interest. The pool-level excess funding account offset should be structured so that (i) it is funded in the event of a failure to meet the minimum Seller's Interest required; (ii) it is invested only in permitted investments for eligible horizontal cash reserve accounts; and (iii) in an early amortization, it makes payments of the funds to ABS investor holders of the ABS in the same manner as collections are paid. Residual ABS interests in excess interest and fees will generally not work for SAFs because it is required that each series of ABS interests distinguish between principal and interest collections, which is not possible for SAFs since SARs typically do not bear interest. A Horizontal Interest, excluding eligible cash reserve accounts, is another potential offset, but must be held for all series and each such Horizontal Interest must be at least equal to the maximum offset taken.

At a reasonable time before the sale of an ABS, the sponsor must disclose a description of (i) the material terms of the Seller's Interest and the specific percentage to be retained and (ii) any Horizontal Interest offsetting the Seller's Interest, if any, including the fair value of such Horizontal Interest. If, however, the sponsor retains an amount of Seller's Interest at closing that is materially different from the amount disclosed pre-sale, then the sponsor must also disclose that amount at a reasonable time after closing. The cut-off date for the data in such disclosure cannot be more than 60 days before its first use in the pre-sale disclosures for securitizations that make payments on a monthly basis, which is applicable to most SAFs.

B. Special Considerations for SAFs Relying on Seller's Interest Form of Risk Retention

Most SAF structures already comply with the Rules using Seller's Interest because the weighted average advance rates for amounts advanced under each series are usually capped at 95 percent in order to comply with EU risk retention regime. To the extent the weighted average advance rate across a facility is less than 95 percent, the sponsor/issuer may consider sizing their equity interest to be no more than the 5 percent minimum. This would allow for the creation and issuance of subordinated securities across the facility that could be sold off by the issuer in the future. Under that scenario, if the sponsor or its wholly-owned affiliate wishes to retain the subordinated securities, they will need to be included as part of the calculation of outstanding ABS interests issued if it intends to sell the securities at a future time.

With respect to owner trust certificates, many SAF structures already impose certain limitations on the hedging, transfer and/or financing of owner trust certificates due to tax restrictions, which should be considered when assessing any hedging or financing of a Seller's Interest. While it is generally prohibited for a sponsor to hedge or transfer its Seller's Interest to any other person or business entity other than a wholly-owned affiliate, financing collateralized by retained risk is permitted if the financing is full recourse, subject to any transaction-specific tax restrictions and bankruptcy limitations. It is also permissible to hedge against (i) overall market movement, such as movement of market interest rates (but not the spread risk associated with the ABS interest that is otherwise considered part of the credit risk); (ii) currency exchanges; (iii) home prices; or (iv) the overall value of a particular broad category of ABS.

Offering documents are not typically required for VFN-only issuances, so sponsors should seek to comply with the disclosure requirements under the Rules by including additional language in the form of certifications in the VFN indenture supplement or other SAF documentation, such as the Note itself or related note purchase agreement. As for ongoing reports or compliance, the commentary to the Rules notes that payment date reporting will likely be sufficient for the disclosure of monthly confirmation of compliance to investors.

All ABS interests issued prior to December 24, 2016 will be grandfathered in. Should the Seller's Interest be the method that a sponsor chooses to use to comply with the Rules, the sponsor will have to continue holding any Seller's Interest that was maintained prior to the effective date, and going forward, supplement the retention with the difference in the form of a Horizontal Interest for each series issued to investors after December 24, 2016. For example, if the sponsor held a Seller's Interest of 2 percent prior to the effective date, then after the effective date, the sponsor would be required to retain at least a 3 percent Horizontal Interest for each ABS interest issued to investors. Notwithstanding the foregoing, since the majority of facilities currently have a weighted average advance rate of less than 95 percent, sponsors of most master trusts with issuances prior to the effective date should already hold the required risk retention, and would just need to focus on the required disclosures.

IV. Conclusion

The new risk retention requirements for SAFs go into effect on December 24, 2016. The structured finance and securitization team at Hunton & Williams is a market leader in structuring revolving pool securitizations such as SAFs and compliance with the new risk retention requirements for SAFs. Please contact our team regarding compliance with the Rules and any questions with respect to our SAF practice generally.

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