

Client Alert

December 2015

Reminder—Compliance Date for RMBS Risk Retention Rules is Right Around the Corner

Participants in the securitization market are reminded that on December 24, 2015, the credit risk retention rules (collectively, the “Rule”) jointly prescribed by three federal banking regulators, two federal housing agencies and the Securities and Exchange Commission will go into effect with respect to residential mortgage-backed securities (“RMBS”). Other asset classes subject to the Rule have another year before compliance is required. Below is a brief reminder of what the Rule requires for an RMBS transaction.

General Risk Retention Requirements

Subject to certain exceptions, the Rule, which applies to both public and private securitizations, requires the sponsor of an RMBS transaction to retain not less than five percent of the credit risk of the securitized assets in that transaction. The Rule also generally prohibits the sponsor from directly or indirectly hedging or transferring the credit risk that it is otherwise required to retain. The transfer and hedging restrictions expire for the sponsor of an RMBS on or after the date that is the later of (a) five years after the closing date of the securitization or (b) the date on which the total unpaid principal balance of the assets is reduced to 25 percent of the original unpaid principal balance as of the closing date of the securitization (but in any event no later than seven years after the closing date).

Choosing the Form of Risk Retention

The Rule permits the following forms of risk retention: (i) an eligible horizontal residual interest, (ii) an eligible vertical interest or (iii) some combination of the two.

- *Eligible Horizontal Residual Interest:* An eligible horizontal residual interest is an interest in a single class or multiple classes of securities that represents the most subordinate claim to payments of both principal and interest (excluding any noneconomic REMIC residual interest). While the sponsor may satisfy its risk retention requirement exclusively through this horizontal option, the amount of the retained interest must be at least five percent of the “fair value” (as determined according to generally accepted accounting principles) of all RMBS issued as part of the securitization. As discussed further below, an eligible horizontal cash reserve account in the amount equal to the eligible horizontal residual interest also may be used by the sponsor to meet the risk retention requirements for an RMBS transaction.
- *Eligible Vertical Interest:* An eligible vertical interest is either (i) an interest in each class of RMBS issued in the securitization that constitutes the same proportion of each class issued (excluding any REMIC residual interests) or (ii) a single vertical security entitling the holder to a specified percentage of the amounts paid on each class of RMBS issued in such transaction. Unlike the horizontal option, the vertical option requires the retained interest to be at least five percent of the face amount of the RMBS instead of the fair value.
- *Combination of Horizontal and Vertical Interest:* The sponsor may also retain a combination of an eligible horizontal residual interest and an eligible vertical interest to satisfy the risk retention requirements, provided the percentage of the fair value represented by the eligible horizontal

residual interest and the percentage represented by the eligible vertical interest equal not less than five percent.

In lieu of retaining all or any part of an eligible horizontal residual interest, the sponsor also has the option to fund an eligible horizontal cash reserve account in the amount equal to the eligible horizontal residual interest. The account must be held by a trustee in cash or cash equivalents, and amounts in the account may be released only to satisfy payments on RMBS interests or to pay critical expenses of the trust unrelated to credit risk when the issuing entity has insufficient funds to pay the amounts or expenses due on any payment date.

Identifying the Sponsor

Although the Rule requires that the “sponsor” of the transaction retain the risk for that transaction, under some circumstances it may be challenging to identify who the sponsor is for purposes of the Rule. The Rule defines the “sponsor” as a “person who *organizes and initiates* a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.” The adopting release of the Rule states that the sponsor must have “actively participated in the organization and initiation activities that would be expected to impact the quality of the securitized assets underlying the asset-backed securitization transaction, typically through underwriting and/or asset selection.”

The adopting release further notes that an entity that “serves only as a pass-through conduit for assets that are transferred into a securitization vehicle, or that only purchases assets at the direction of an independent asset or investment manager, only pre-approves the purchase of assets before selection, or only approves the purchase of assets after such purchase has been made would not qualify as a ‘sponsor’....” Finally, the adopting release is clear that the sponsor cannot be a party that merely provides a “rubber stamp” to the transaction. While the definition of sponsor is relatively clear, the guidance in the adopting release indicates that identifying the sponsor may be very fact-specific in certain scenarios. We believe, however, that there are specific steps that transaction participants can take to gain greater certainty that they have appropriately identified the correct “sponsor” in the transaction. To ensure an RMBS transaction is appropriately structured to comply with the Rule, transaction parties are strongly encouraged to contact counsel as early as possible in the transaction process to discuss.

For deals in which more than one transaction party would meet the definition of “sponsor” under the Rule, at least one such sponsor must retain five percent of the risk of the transaction. While this percentage cannot be divided between multiple sponsors, the Rule does allow the sponsor to transfer the retained risk to a “majority-owned affiliate.” The Rule defines a “majority-owned affiliate” of a person as “an entity (other than the issuing entity) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, such person.” Majority control means ownership of more than 50 percent of the equity of an entity, or ownership of any other controlling financial interest in the entity (as determined according to generally accepted accounting principles). Furthermore, the Rule allows any originator that originated at least 20 percent of the assets to hold a portion of the required risk retention, provided that such originator (i) holds at least 20 percent of the aggregate risk retention amount, (ii) does not hold a greater portion than the percentage of the assets in the pool that it originated and (iii) purchases the interest from the sponsor at a price equal to the amount by which the sponsor’s required risk retention is reduced and such purchase price is paid in the form of cash or a reduction in the price paid by the sponsor to that originator for the assets.

Disclosure Requirements

The Rule requires the sponsor to make certain disclosures at a reasonable time prior to the sale of the RMBS in a transaction and a reasonable time after the closing date of the transaction. Unfortunately, the Rule does not provide guidance on what is a “reasonable time.” The method of risk retention chosen by the sponsor affects the disclosure requirements.

- *Eligible Horizontal Residual Interest:* If the sponsor chooses to retain risk through an eligible horizontal residual interest, the sponsor must disclose to investors (among other things): (i) the fair

value of all the RMBS to be retained as a percentage of the fair value of all the RMBS issued in the securitization (or, if specific prices are not available yet, a range of fair values based on estimated prices), (ii) a description of the method by which the disclosed fair values were determined, (iii) the key inputs and assumptions (such as discount rate, prepayment speed, lag time and default rates) used to calculate fair value and (iv) a summary description of the reference data set or other historical information used to develop the key inputs and assumptions. The sponsor is then required at a reasonable time after the closing of the securitization to calculate and disclose the fair value of the retained risk based on actual prices and tranche sizes of the RMBS issued in the transaction and any material differences between valuation methodology, key inputs and assumptions used to calculate fair value prior to the sale of the RMBS and those used following the sale of the RMBS. A sponsor may be hesitant to disclose such information to the extent it believes the inputs and assumptions used to determine fair value are of a proprietary nature essential to its business and may, instead, choose to comply with the Rule by holding a vertical interest, which would not require disclosure of such critical inputs and assumptions.

- *Eligible Vertical Interest:* If the sponsor chooses to retain risk through an eligible vertical interest, the disclosure requirements are much simpler, as the sponsor is not required to make a fair value determination of the retained risk. Instead, the sponsor must disclose to investors (i) the form of the eligible vertical interest, (ii) the percentage of the RMBS that the sponsor is required to retain and (iii) a description of the material terms of the vertical interest, including the amount that the sponsor expects to retain at issuance. Post-closing disclosure is only required if there are any material changes to the pre-closing disclosure.

If the sponsor retains risk through the funding of an eligible horizontal cash reserve account, then the sponsor must disclose to investors (i) the amount to be placed in the reserve account at closing and the fair value of the eligible horizontal residual interest that the sponsor is required to fund through the reserve account, (ii) a description of the material terms of the reserve account and (iii) all of the same information required for an eligible horizontal residual interest.

If the sponsor retains a combination of an eligible horizontal residual interest and an eligible vertical interest, the disclosures applicable to both such interests must be provided to investors.

Exemptions

While generally the information provided above applies to all securitizers, exemptions exist for certain types of assets and transactions. The Rule provides that securitizations of RMBS are exempt from any risk retention requirements if: (i) all of the assets that collateralize the RMBS are “qualified residential mortgages” (which is defined to be equal to the “qualified mortgage” definition prescribed by the Consumer Financial Protection Bureau under its ability-to-repay rules) (a “QRM”), (ii) none of the assets is backed by pre-existing RMBS and (iii) the sponsor provides a certification from the depositor regarding (i) and (ii). The Rule also grants an exemption for all RMBS collateralized solely by (i) three- to four-unit owner-occupied residential mortgage loans that are deemed to be for business purposes, so long as they otherwise satisfy the QRM requirements, (ii) certain “community focused residential mortgages” and (iii) seasoned loans that meet certain specifications. Finally, so long as Fannie Mae and Freddie Mac are in conservatorship, any RMBS that they issue or guarantee will satisfy risk retention requirements.

If you have any questions regarding the risk retention rules or this client alert, please contact **Eric Burner**, **Bob Hahn** or **Brent Lewis**, or any member of our [Structured Finance team](#).

© 2015 Hunton & Williams LLP. 200 Park Avenue, New York, NY 10166. Attorney advertising materials. These materials have been prepared for informational purposes only and are not legal advice. This information is not intended to create an attorney-client or similar relationship. Please do not send us confidential information. Past successes cannot be an assurance of future success. Whether you need legal services and which lawyer you select are important decisions that should not be based solely upon these materials.