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Federal Agencies Adopt Final Rules on Credit Risk Retention for Asset-Backed Securities

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TO: FIXED-INCOME ADVISORY COMMITTEE No. 18-14
SEC RULES MEMBERS No. 44-14
CLOSED-END INVESTMENT COMPANY MEMBERS No. 30-14
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 33-14
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 29-14 RE: FEDERAL AGENCIES ADOPT FINAL RULES ON CREDIT RISK RETENTION FOR ASSET-BACKED SECURITIES

Recently, the Securities and Exchange Commission ("SEC"), Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, and Department of Housing and Urban Development (together, the "Agencies") jointly adopted final rules ("Final Rules") that implement the credit risk retention requirements of Section 15G of the Securities Exchange Act of 1934 ("Exchange Act"), as added by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). [1] The Final Rules are largely similar to the rules the Agencies reproposed in August 2013 ("Reproposal"), although the Agencies made a number of changes to respond to public comments. [2] The Final Rules will be effective one year after the date of publication in the Federal Register with respect to asset-backed securities ("ABS") collateralized by residential mortgages, and two years after the date of publication in the Federal Register for all other classes of ABS. Those Final Rules that are most relevant to registered investment companies ("registered funds") are summarized below.

Background

The Final Rules implement the requirement of Section 15G of the Exchange Act, which requires the Agencies to jointly adopt rules that: (i) require a securitizer of an ABS to retain not less than five percent of the credit risk of any asset that the securitizer, through the issuance of the ABS, transfers, sells, or conveys to a third party; and (ii) prohibit a securitizer from hedging or otherwise transferring the credit risk that the securitizer is required to retain under Section 15G or the rules adopted by the Agencies. Consistent with

Section 15G, the Final Rules also exempt certain types of securitization transactions from the risk retention requirements and establish a lower risk retention requirement for other types of securitization transactions.

Standard Risk Retention Options

The Final Rules, consistent with the Reproposal, permit a variety of standard options for a sponsor to satisfy the five percent minimum risk retention requirement, including by retaining an "eligible vertical interest," [3] an "eligible horizontal residual interest," [4] or any combination of the two, as long as the combined total interest is no less than five percent.

- While the Reproposal would have required sponsors to measure their risk retention requirement for the standard options using fair value, determined in accordance with U.S. generally accepted accounting principles ("GAAP"), the Final Rules retain this requirement for only an eligible horizontal interest, and not for an eligible vertical interest. The sponsor of an eligible horizontal interest must provide certain disclosures regarding its fair value methodology.
- As under the Reproposal, a sponsor may satisfy its risk retention obligation using the vertical option by either retaining at least five percent of the fair value of each class of ABS interests issued as part of the securitization transaction, or by retaining a "single vertical security." [5]
- The Final Rules do not include the cash flow restriction that was proposed to be included as part of an eligible horizontal residual interest, or any alternative cash flow restriction. The Agencies concluded that cash flow restrictions could lead to unintended consequences or have a disparate impact on some asset classes.

Alternative Risk Retention Options

In addition to the standard risk retention options, the Final Rules include a number of alternative risk retention options which recognize the particular characteristics of certain classes of ABS. The alternative risk retention options that may be of interest to registered funds include:

Asset-Backed Commercial Paper Conduits

The Final Rules, like the Reproposal, include an alternative risk retention option for sponsors of asset-backed commercial paper ("ABCP") conduits, which may rely on this option or one of the standard risk retention options. [6] Consistent with the Reproposal, unfunded forms of credit enhancement, such as standby letters of credit, guarantees, repurchase agreements, and asset purchase agreements, would not satisfy the risk retention requirements. The ABCP option is substantially similar to the option under the Reproposal, although the Agencies made several changes in the final rules to reflect public comments. Under the Final Rules, among other things:

- The ABCP conduit must meet the definition of an "Eligible ABCP Conduit," which imposes certain structural, liquidity coverage, and collateral requirements.
    - A regulated liquidity provider must have entered into a legally binding commitment to provide 100% liquidity coverage of all ABCP issued by the issuing entity. Partially-supported ABCP conduits are not eligible for the ABCP option.

[7]

- The Final Rules limit the types of assets that may be acquired by an eligible ABCP conduit. [8]
- The ABS interests must be acquired by the ABCP conduit in an initial issuance by or on behalf of an intermediate SPV: (1) directly from the intermediate SPV, (2) from an underwriter of the ABS interests issued by the intermediate SPV; or (3) from another person who acquired the ABS interests directly from the intermediate SPV.
- The Final Rules provide that an eligible ABCP conduit must be collateralized solely by ABS interests acquired from intermediate SPVs and servicing assets.
- In a change from the Reproposal, the Final Rules permit eligible ABCP under the ABCP option to have a maturity at the time of issuance not exceeding 397 days. [9]

The Final Rules also require specified disclosures to ABCP investors before or contemporaneously with the first sale of ABCP to the investor, and on at least a monthly basis to all conduit investors. [10] The disclosures must be based on information as of a date not more than 60 days prior to the date of first use with investors.

Municipal Bond "Repackaging" Securitizations

The Final Rules, like the Reproprosal, provide an alternative risk retention option for sponsors of municipal bond "repackaging" securitizations, [11] the most common of which are tender option bond programs ("TOBs"). While the Agencies did not exempt TOBs from the risk retention requirements, they included in the Final Rules a number of changes from the Reproposal that reflect the comments of ICI and others. The Final Rules provide a definition of a "qualified tender option bond entity" [12] and a definition of a "tender option bond." The Final Rules provide that a sponsor with respect to tender option bonds by a qualified tender option bond entity, as defined under the rules, may satisfy its risk retention obligation by complying with the standard risk retention methods (i.e., vertical, horizontal, or a combination thereof) or the following TOB risk retention options: [13]

- The sponsor may retain an interest that upon issuance meets the requirements of an eligible horizontal residual interest but that upon the occurrence of a "tender option termination event," as defined in Section 4.01(5) of IRS Revenue Procedure 2003-84, will meet the requirements of an eligible vertical interest. As requested by ICI, the Agencies clarified in the Adopting Release that a residual interest in a TOB trust would satisfy this requirement. [14]

- The sponsor may satisfy its risk retention requirements by holding municipal securities from the same issuance of municipal securities deposited in the qualified tender option bond entity, the face value of which retained municipal securities is equal to 5 percent of the face value of the municipal securities deposited in the qualified tender option bond entity.

In response to comments, the Agencies revised the definitions of "qualified tender option bond entity" and "tender option bond" in the Final Rules in several key respects:

- The Final Rules permit a qualified tender option bond entity to issue more than one residual equity interest. The Adopting Release clarifies, in this regard, that a TOB trust relying on the TOB risk retention option could have more than one party that meets the definition of "sponsor," for purposes of the rule, and that either the bank or

a residual holder could be designated as the sponsor for risk retention purposes. [15]
    - The Adopting Release clarifies that the designation of a party as sponsor for purposes of the Final Rules does not mean that party is a "sponsor" for purposes of other rules and regulations, including Rule 2a-7 under the Investment Company Act of 1940 ("1940 Act") or Section 13G of the Bank Holding Company Act (the Volcker Rule).
- The Final Rules permit TOBs with a notice period up to 397 days, in order to correspond to the maximum remaining maturity of securities allowed to be purchased by money market funds under Rule 2a-7 under the 1940 Act. [16]
- The TOBs issued by the qualified tender option bond entity are not required to be eligible assets under Rule 2a-7 under the 1940 Act.

The Final Rules, with minor changes from the Reproposal, require that the sponsor provide, or cause to be provided, specified written disclosures to potential investors prior to the sale of the ABS and, upon request, to the SEC and the appropriate Federal Banking agency, if any. The general prohibitions on transfer and hedging under the Final Rules also apply to any municipal securities retained by the sponsor with respect to an issuance of TOBs by a qualified tender option bond entity under the Final Rules. The Adopting Release also addresses the timing of applicability of the Final Rules, stating that the Final Rules will apply to TOB issuances that take place after the effective date of the rule, regardless of when the TOB trust that issued the securities was formed. [17]

Commercial Mortgage-Backed Securities

Consistent with the Reproposal, the Final Rules permit a sponsor of commercial mortgage-backed securities ("CMBS") to meet its risk retention requirements if a third-party purchaser, or "B-piece buyer," acquires an eligible horizontal residual interest in the issuing entity. [18] The CMBS risk retention option is subject to eight conditions, most of which the Agencies adopted as reproposed, or with slight modifications. [19]

One condition of the CMBS option is that, at any time, there may not be more than two third-party purchasers of an eligible horizontal residual interest, and that if there are two third-party purchasers, their interests must be held on a pari passu basis. The Agencies declined to adopt ICI's recommendation [20] that the definition of third-party purchaser should be expanded to permit multiple funds that are managed by the same or an affiliated investment adviser to serve as third-party purchasers, noting that "further expansion of the definition of third-party purchaser is not necessary and would dilute the risk required to be retained by a sponsor or third-party purchaser." [21]

Another condition of the CMBS option relates to the ability of a third-party purchaser that is satisfying the risk retention obligation on behalf of the sponsor, to transfer its retained interest. The Final Rules, like the Reproposal, provide an exception to the transfer and hedging restrictions under Section 15G of the Exchange Act. The Final Rules permit a third-party purchaser to transfer its retained interest to another third-party purchaser at any time after five years after the date of the closing of the securitization transaction, provided that the transferee satisfies the conditions applicable to the initial third-party purchaser under the CMBS option. The Final Rules also permit transfers by any such subsequent third-party purchaser to any other purchaser satisfying the criteria applicable to initial third-party purchasers. While ICI and other commenters had recommended that the Agencies shorten this transfer period, the Agencies declined to do so.

Open Market CLOs

The Agencies confirm in the Adopting Release that managers of collateralized loan obligations ("CLOs") are "securitizers" for purposes of the Final Rules, and are subject to risk retention requirements. The Final Rules, however, provide an alternative risk retention option for "open market CLOs," as defined under the rules. [22]

ABS Not Subject to the Risk Retention Requirements

The Final Rules, like the Reproposal, do not subject certain ABS sponsors to the risk retention requirements, including, but not limited to:

Government-Sponsored Enterprises

The Agencies adopted without change the rule that deems ABS guaranteed by the Federal National Mortgage Association ("Fannie Mae") or the Federal Home Loan Mortgage Corporation ("Freddie Mac," and together with Fannie Mae, the "GSEs") while they operate under the conservatorship or receivership of the Federal Housing Finance Agency with capital support from the United States, or any successor limited life regulated entities, as satisfying the risk retention requirements. [23] Similarly, the hedging and finance provisions of the Final Rules would not apply to the GSEs or any successor limited-life regulated entities, as long as the GSEs (or any successor entity) are operating consistently with the conditions set out in the Final Rules.

Qualified Residential Mortgages

Section 15G of the Exchange Act exempts sponsors of securitizations from the risk retention requirements if all of the assets that collateralize the securities issued in the transaction are "qualified residential mortgages" ("QRMs"). Section 15G directs the agencies to define QRM jointly, and requires that the definition of a QRM be "no broader than" the definition of a "qualified mortgage" ("QM"), which definition was adopted last year by the Consumer Finance Protection Bureau ("CFPB"). [24] Consistent with the Reproposal, the Agencies adopted a definition of QRM that aligns with QM, as defined in Section 129C of the Truth in Lending Act and its implementing regulations, as may be amended from time to time. [25] By aligning the QRM definition with the QM definition, the scope of eligible loans includes, among other things, any closed-end loan secured by a dwelling, including, but not limited to: second liens, refinancing, second or vacation homes, and home equity loans. In the Final Rules, the Agencies have also added a requirement, however, that they review the definition of QRM not later than four years after the effective date of the Final Rules with respect to securitizations of residential mortgages, five years after the completion of that initial review, and every five years thereafter. In addition, the Agencies must commence a review at any time upon the request of any one of the Agencies. [26]

Hedging, Transfer, and Financing Restrictions

Section 15G(c)(1)(A) of the Exchange Act provides that the risk retention rules shall prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset. Under the Final Rules, a sponsor retaining the credit risk generally may not sell or otherwise transfer any interest or other assets the sponsor is required to retain under the Final Rules except to a majority-owned affiliate that remains subject to the same restrictions. [27] The Final Rules, like the Reproposal, however, permit certain hedging activities, and provide sunset periods for the

hedging and transfer restrictions.

For residential mortgage-backed securities ("RMBS"), the transfer and hedging restrictions under the Final Rules will expire on or after the date that is the later of:

- Five years after the date of the closing of the securitization transaction; or
- The date on which the total unpaid principal balance of the residential mortgages that collateralize the securitization transaction has been reduced to 25 percent of the total unpaid principal balance of such residential mortgages at the closing of the securitization transaction. [28]

For all other ABS interests, the prohibitions on sale and hedging under the Final Rules will expire on or after the date that is the latest of:

- The date on which the total unpaid principal balance (if applicable) of the securitized assets that collateralize the securitization transaction has been reduced to 33 percent 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 percent of the total unpaid principal obligations of the ABS interests at closing of the securitization transaction; or
- Two years after the date of the closing of the securitization transaction.

Sarah A. Bessin
Senior Counsel

endnotes

[1] See Credit Risk Retention, available at http://www.sec.gov/rules/final/2014/34-73407.pdf ("Adopting Release").

[2] For a summary of the Reproposal, please see ICI Memorandum No. 27561 (Sept. 13, 2013), available at http://www.ici.org/my_ici/memorandum/memo27561. See Letter to Mr. Kevin M. O'Neill, Deputy Secretary, Securities and Exchange Commission, et al., from Dorothy M. Donohue, Acting General Counsel, dated July 15, 2014, available at http://www.ici.org/pdf/28272.pdf ("ICI 2014 Letter"); and Letter to Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, et al., from Karrie McMillan, General Counsel, dated Oct. 30, 2013, available at http://www.ici.org/pdf/27658.pdf ("ICI 2013 Letter"). For a summary of the original 2011 proposal, please see ICI Memorandum No. 25162 (May 2, 2011), available at http://www.ici.org/my_ici/memorandum/memo25162. ICI submitted two comment letters on the original proposal, the second jointly with several banks. See Letter to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, et al., from Karrie McMillan, General Counsel, Investment Company Institute, dated July 29, 2011, available at http://www.ici.org/pdf/25368.pdf ("ICI 2011 Letter"); and Letter to Office of the Comptroller of the Currency, et al., from ICI, et al., dated August 31, 2012, available at http://www.ici.org/pdf/26456.pdf ("ICI 2012 Letter").

[3] Under the Final Rules, an "eligible vertical interest" means with respect to any

securitization transaction, a single vertical security or an interest in each class of ABS interests in the issuing entity issued as part of the securitization transaction that constitutes the same portion of each such class. Rule §_.3.

[4] Under the Final Rules, an "eligible horizontal residual interest" means, with respect to any securitization transaction, an ABS interest in the issuing entity: (1) that is an interest in a single class or multiple classes in the issuing entity, provided that each interest meets, individually or in the aggregate, all of the requirements of the definition; (2) with respect to which, on any payment date or allocation date on which the issuing entity has insufficient funds to satisfy its obligation to pay all contractual interest or principal due, any resulting shortfall will reduce amounts payable to the eligible horizontal residual interest prior to any reduction in the amounts payable to any other ABS interest, whether through loss allocation, operation of the priority of payments, or any other governing contractual provision (until the amount of such ABS interest is reduced to zero); and (3) that, with the exception of any non-economic real estate investment conduit (REMIC) residual interest, has the most subordinated claim to payments of both principal and interest by the issuing entity. Id.

[5] A single vertical security is an ABS interest entitling the holder to a specified percentage (e.g., five percent) of the principal and interest paid on each class of ABS interest in the issuing entity (other than such single vertical security) that results in the security representing the same percentage of fair value of each class of ABS interests.

[6] See Rule §_.6. The Agencies note that reliance on the ABCP option by the sponsor of an eligible ABCP conduit does not relieve the originator-seller of a risk retention obligation it may have as a result of being the sponsor of ABS issued by an intermediate special purpose vehicle ("SPV") of the ABCP conduit. Adopting Release, supra note 1, at 159.

[7] While the Agencies recognized the concerns expressed by ICI and others that a significant number of existing partially-supported conduits will likely not be able to rely on the ABCP option, the Agencies state that "a liquidity facility of the type described by commenters, that reduces the obligation of the liquidity provider to provide funding based on a formula that takes into consideration the amount of non-performing assets could serve to insulate the liquidity provider from the credit risk of non-performing assets in the securitization transaction. The ABCP option is designed to accommodate conduits that expose the liquidity provider to the full credit risk of the assets in the securitization . . ." Adopting Release, supra note 1, at 164.

[8] Permitted assets include: (i) ABS interests collateralized solely by assets originated by an originator-seller and by servicing assets; (ii) special units of beneficial interest (or similar ABS interests) in a trust or SPV that retains legal title to leased property underlying leases originated by an originator-seller that were transferred to an intermediate SPV in connection with a securitization collateralized solely by such leases and by servicing assets; (iii) ABS interests in a revolving pool securitization collateralized solely by assets originated by an originator-seller and servicing assets; or (iv) ABS interests described in (i), (ii), or (iii) above that are collateralized, in whole or in part, by assets acquired by an originator-seller in a business combination that qualifies for business combination accounting under GAAP, and, if collateralized in part, the remainder of such assets are assets described in (i), (ii), or (iii) above.

[9] Under the Reproposal, maturity was limited to a maximum of nine months.

[10] The ABCP sponsor must provide, or cause to be provided, upon request, to the SEC and its appropriate Federal banking agency, if any, in writing, all of the information required to be provided to investors and the name and form of organization of each originator-seller that will retain or has retained a risk retention interest in the securitization transaction.

[11] See Rule §_.10.

[12] A qualified tender option bond entity is limited to holding tax-exempt municipal securities with the same municipal issuer and the same underlying obligor or source of payment, and servicing assets. The Agencies declined to expand permitted assets under the Final Rules.

[13] The Final Rules also provide that a sponsor may combine any of the standard or TOB risk retention options in any combination, as long as the sum of the percentages held in each form equals at least five.

[14] The Adopting Release states that: "The agencies believe that a residual interest in a qualified tender option bond entity would meet the requirements of an eligible horizontal residual interest before, and an eligible vertical interest after, the occurrence of a tender option termination event if: (i) prior to the occurrence of a tender option termination event, the residual holder bears all the market risk associated with the underlying tax-exempt municipal security; and (ii) after the occurrence of a tender option termination event, any credit losses are shared pro rata between the tender option bonds and the residual interest." Adopting Release, supra note 1, at 248.

[15] Adopting Release, supra note 1, at 246-7. ICI had requested that multiple fund residual holders be permitted under the Final Rules in order to reflect the common practice of multiple funds in a fund complex investing in residuals issued by a single TOB trust. See, e.g., ICI 2014 Letter, supra note 2. While the Final Rules would permit multiple fund residual holders, the Final Rules appear to require that a single entity be designated as the sponsor for risk retention purposes, and would not appear to permit sharing of the five percent risk retention obligation among multiple parties.

[16] The notice period of TOBs eligible to be issued under the Reproposal would have been 30 days.

[17] Adopting Release, supra note 1, at 248-9.

[18] See Rule §_.7. The interest must take the same form, amount, and manner as the sponsor would have been required to retain under the horizontal risk retention option.

[19] Id.

[20] See ICI 2013 Letter, supra note 2.

[21] Adopting Release, supra note 1, at 178.

[22] See Rule §_.9.

[23] See Rule §_.8.

[24] Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 FR 35430 (June 12, 2013), available at

http://www.gpo.gov/fdsys/pkg/FR-2013-06-12/pdf/2013-13173.pdf. The final QM rule was effective January 10, 2014.

[25] See Rule § _.13.

[26] See Rule § _.22.

[27] See Rule § _.12.

[28] The Final Rules further provide that the prohibitions on transfer and hedging for RMBS will expire, in any event, no later than seven years after the date of the closing of the securitization transaction.
