

## Ten key points from the final risk retention rule

This week six federal agencies (Fed, OCC, FDIC, SEC, FHFA, and HUD) finalized their joint asset-backed securities (ABS) risk retention rule. As expected, the final rule requires sponsors of ABS to retain an interest equal to at least 5% of the credit risk in a securitization vehicle.

- 1. A win for the mortgage industry:** The final rule effectively broadens the original proposal's exemption from risk retention requirements for Qualified Residential Mortgages (QRM) by tying the definition of QRM to the Consumer Finance Protection Bureau's definition of Qualified Mortgage (QM). This alignment abandons the proposal's most stringent requirements to obtain the QRM exemption, including that a residential mortgage have at least a 20% down payment. The final rule also provides an additional exemption for certain mortgages that would not meet the QRM standards, e.g., community-focused residential mortgages. The immediate impact of the rule on the industry is further muted, given the significant amount of mortgages issued by government sponsored entities (i.e., Fannie Mae, Freddie Mac, and Ginnie Mae) that are currently exempt from the rule's requirements. It may however be too soon for the industry to celebrate, as the final rule states that the agencies will reassess the effectiveness of the QRM definition at reducing securitization risk at most four years from now, and every five years thereafter.
- 2. More pressure on liquidity:** The final rule complicates daily operations for dealers trying to manage their trading practices under the Volcker Rule.<sup>1</sup> Dealers have historically been expected to make markets for their underwritten vehicles which results in the dealer providing liquidity by cashing out investors who may choose to sell their interests in the vehicle. These transactions in turn increase the dealer's share of the vehicle which may impact consolidation, thus subjecting the vehicle itself to the Volcker Rule's investment restrictions. Therefore, we expect that banks may be less willing to make markets for their underwritten securitization vehicles, negatively impacting liquidity for securitized products.
- 3. Capital impact on banks creates opportunities for nonbanks:** The final rule allows sponsors to retain risk as either an eligible horizontal retained interest (EHRI) (i.e., retaining the most subordinate 5% of the vehicle), an eligible vertical interest (EVI) (i.e., retaining a "slice" of each tranche of the vehicle's securities), an "L-shaped" interest (i.e., a combination of horizontal and vertical), or an eligible horizontal cash reserve account. Although all retained interests will lead to higher regulatory capital requirements for banks, as they are held as balance sheet assets, holding horizontal interests will be particularly punitive on banks, as EHRI will require a dollar-for-dollar capital charge for banks in most instances. Because the final rule prohibits sponsors from transferring retained interests for a period of time (at least five years for residential mortgages and two years for all other asset classes), retained interests will generally receive non-covered treatment under the US Basel III market risk requirements. Therefore, nonbank sponsors and capital market participants that are not subject to banking capital requirements may be more inclined to utilize the EHRI, particularly for asset classes where retaining equity is already common practice. The final rule thus further incentivizes the current trend of migration of certain products from banking portfolios to nonbanks.

<sup>1</sup> See PwC's *A closer look, Volcker rule clarity: Waiting for Godot* (May 2014).

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- 4. Agencies conclude CLO managers are sponsors:** Despite concerns expressed by collateralized loan obligation (CLO) market participants, the final rule clarifies that CLO managers must meet either the minimum risk retention requirement for each CLO securitization transaction, or use the alternative lead arranger option. Under the lead arranger option, risk retention could be satisfied for open-market CLOs if the lead arranger (e.g., underwriters) for each CLO-eligible loan retains at least 5% of the contributed loan and meets other requirements. As underwriters are unlikely to want to retain a larger portion of the risk than they are required to, we do not expect the lead arranger option to be widely utilized. Therefore, we anticipate that CLO issuance will shift toward managers who have adequate capital to meet their own retention requirements without reliance on underwriters.
- 5. No relief for auto, commercial real estate, or commercial loans:** The final rule maintains the 2013 re-proposal's treatment of qualified auto, commercial real estate, and commercial loans, despite the industry's concern that the re-proposal's provisions were overly-conservative and inconsistent with current business practices. Although these claims mirror those made by the residential mortgage industry, regulators did not extend a similar relief to these classes of securities. Therefore, sponsors seeking to avoid risk retention will need to evaluate business practices to shift their securitization activities to assets that qualify for the one of the final rule's exemptions (e.g., qualified residential mortgages).
- 6. Risk retention methods remain largely as proposed but cash flow restrictions scrapped:** The final rule retains the three proposed methods of risk retention, i.e., EHRI, EVI, and a combination of EHRI and EVI, "L-shaped." However, the final rule removes the proposal's restrictions on EHRI cash flows, which were meant to ensure that sponsors do not structure the vehicle in a way that favors the most junior tranche (in which the sponsor retains risk) above other investors when distributing returns. These restrictions were abandoned due to difficulties in operationalizing them, and because they might not have yielded the desirable effect (i.e., aligning investors' risk with the sponsor's). Despite this change, we expect sponsors to migrate towards the EVI, avoiding the comprehensive fair value disclosures required for retained horizontal interests.
- 7. More transparency for investors:** The final rule requires sponsors disclose the fair value of EHRI's and allows sponsors to provide a range of fair values where specific price, size, or interest rate information for each tranche of the securitization is not available. Sponsors must disclose the closing date fair value of retained EHRI's within a reasonable time after the closing of the securitization. But the sponsor must provide significant disclosures regarding their EHRI fair value calculations, including a description of their calculation methodology, quantitative information about key inputs and assumptions (including prepayment, default, severity, and discount rates), and a description of the historical data set or other market information used to develop the assumptions. Increased fair value disclosure requirements will likely add costs to the securitization process.
- 8. Uncertainty regarding balance sheet consolidation:** Sponsors who do not meet certain asset-specific exemptions will be required to retain an interest exceeding 5% of the fair value of issued ABS interests in securitization. The industry has been concerned that a high risk retention requirement that gives the sponsor more interest in the vehicle (together with a sponsor's high degree of control over the vehicle) may satisfy two legs of the consolidation analysis (i.e., power and economics), thereby requiring the sponsor to consolidate the securitization vehicle on its balance sheet. To further complicate this issue, the final rule comes at a time when the FASB is finalizing updates to its consolidation guidance, thereby increasing the uncertainty of the circumstances under which consolidation will be required in the future.
- 9. Restrictions on transfers and hedging remain largely the same:** Sponsors continue to face prohibitions from transferring retained interests, hedging credit risk of their retained interests, or pledging retained interests as collateral without full recourse. Therefore, we expect the retained interests to increase the size of sponsors' balance sheets, especially for frequent issuers.
- 10. Significant disagreement among the agencies remains:** The FDIC and SEC meetings to finalize the rule were dominated by disagreement regarding the appropriateness of aligning the QRM with the QM (which have different ultimate objectives) and whether alignment incentivizes higher quality asset securitizations. In addition, dissenting commissioners also objected to the agencies' lack of response to concerns around the treatment of collateralized loan obligations (CLOs) that remains unchanged in the final rule despite significant industry push back.

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