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The Latest from Dodd-Frank: Credit Risk Retention Rule Finalized

The ultimate effect on securitizations and the residential mortgage market remains uncertain.

In the latest significant rulemaking arising out of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), on October 22, six federal financial and housing agencies finalized long-awaited rules on credit risk retention requirements for securitizations (the Final Rule), implementing the requirements of section 15G of the Securities Exchange Act of 1934 (Exchange Act),[1] as added by section 941 of the Dodd-Frank Act. The joint rulemaking was issued by the U.S. Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (the Board), the Federal Deposit Insurance Corporation (FDIC), the Federal Housing Finance Agency (FHFA), the Securities and Exchange Commission (SEC), and the Department of Housing and Urban Development (HUD).[2] The Final Rule and accompanying discussion, at almost 690 pages, comes after a lengthy 3.5-year process, during which two proposed rules were issued (one in April 2011[3] and one in September 2013[4]), almost 11,000 comments were submitted to the agencies, and both houses of Congress held numerous hearings.

The requirements in the Final Rule will become effective for securitization transactions collateralized by residential mortgages one year after the date of publication in the *Federal Register* (which is expected to occur in the next few weeks) and will become effective for any other securitization transactions two years after that date. Until official publication in the *Federal Register*, the Final Rule is available at http://www.federalreserve.gov/aboutthefed/boardmeetings/bcreg20141022a1.pdf.

The Final Rule generally requires any securitizer[5] of asset-backed securities (ABS) to retain 5% of the credit risk of the assets transferred in connection with a securitization, subject to various exceptions and exclusions. In addition, the Final Rule generally prohibits a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain under section 15G.[6]

For most types of securitizations, risk retention will require a securitizer to retain either an “eligible vertical interest” (a pro rata interest in all ABS interests issued), an “eligible horizontal residual interest” (a first loss interest), or any combination of both.[7] A sponsor of a securitization is permitted to allocate a portion of its retained

1. 15 U.S.C. § 78o-11.

2. The OCC, the Board, the FDIC, the FHFA, the SEC, and HUD are collectively responsible for the joint rules implementing section 15G for securitizations that are collateralized by residential mortgage assets and for defining what constitutes a “qualified residential mortgage.” The OCC, the Board, the FDIC, and the SEC are responsible for adopting joint rules implementing section 15G for securitizations collateralized by all other asset classes and for other specific areas of section 15G.

3. 76 Fed. Reg. 24,089 (Apr. 29, 2011).

4. 78 Fed. Reg. 57,927 (Sept. 20, 2013).

5. “Securitizer” is defined in section 15G as “an issuer of an asset-backed security” or a person who “organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to an issuer.” 15 U.S.C. § 78o-11(a)(3). The Final Rule defines a “securitizer” by incorporating the statutory definition and incorporating the definition of “depositor” (a person that receives or purchases and transfers or sells the securitized assets). Final Rule, Section _.2.

6. Final Rule, Section _.12.

7. Final Rule, Section _.4.

credit risk to an originator of at least 20% of the pool of securitized assets, subject to the framework set out in the Final Rule.[8]

The Final Rule largely adopts the framework of the September 2013 proposed rule, with some modifications, clarifications, and omissions. Significantly, the Final Rule does the following:

- Aligns the definition of a "qualified residential mortgage" (QRM) with the definition of a "qualified mortgage" (QM) under the Truth in Lending Act and as promulgated by the Consumer Financial Protection Bureau (CFPB)[9]
- Provides an additional exemption from risk retention for certain types of community-focused residential mortgages that are not eligible for QRM status under the Final Rule
- Does not adopt provisions that were in the September 2013 proposed rule that (i) would have placed cash flow restrictions on securitizers that hold an eligible horizontal residual interest and (ii) would have required the eligible vertical interest to be measured using a fair value calculation
- Specifically did not adopt an exemption requested by many commentators that would have exempted collateralized loan obligation managers from the risk-retention requirement
- Specifically declined to calibrate the credit risk that must be retained by asset class beyond what is required by section 15G (zero risk retention for automobile, commercial real estate, and commercial loan asset classes that meet certain underwriting standards that are designed to ensure a low credit risk)

The Final Rule implements several exemptions, exclusions, and modified risk-retention requirements authorized under section 15G, including the following:[10]

- Asset-backed securities that are collateralized exclusively by residential mortgages that qualify as QRMs as defined by regulation are exempt from the risk-retention requirements.[11]
- Securitizations of ABS interests collateralized by commercial mortgages, commercial loans, and automobile loans are subject to a lower credit risk-retention requirement if the underlying loans meet specified low-risk underwriting standards (qualifying assets). Qualifying assets can be commingled with nonqualifying assets of a similar type to receive up to a 50% reduction in the minimum required risk-retention amount.[12]
- Foreign-based securitizations with limited connections to the United States and U.S. investors are excluded from the risk-retention requirements under a safe harbor provision.[13]
- There are a variety of specified general exemptions for certain types of securitizations, including exemptions for securitizations of federally insured or guaranteed assets (including healthcare facility mortgage loans, certain federal student loans, ABS interests issued by qualifying public utilities, qualifying seasoned loans [residential mortgage loans and other loans], and ABS interests issued in certain resecuritization transactions).[14]
- Certain specified securitizations are subject to modified risk-retention rules, including qualifying asset-backed commercial paper securitizations,[15] commercial mortgage backed securities,[16] and municipal "tender option bonds."[17]

8. Final Rule, Section _.11.

9. Section 15G requires "qualified residential mortgage" to be defined no broader than the definition of "qualified mortgage" under section 129C of the Truth in Lending Act and its implementing regulations. 15 U.S.C. § 78o-11(e)(4). The QRM definition will be subject to periodic review that is intended to follow and coordinate with the CFPB's statutorily required periodic review of its "qualified mortgage" regulations. Final Rule, Section _.22.

10. 15 U.S.C. §§ 78o-11(c), (e)(1), (e)(2).

11. Final Rule, Section _.13.

12. Final Rule, Sections _.14 - ._18.

13. Final Rule, Section _.20.

14. Final Rule, Section _.19.

15. Final Rule, Section _.6.

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Observations

Section 15G of the Exchange Act and the Final Rule are intended to address what Congress and many of the federal housing and financial regulators viewed as one of the central weaknesses that became evident during the recent financial crisis. Sponsors of securitizations typically had no risk exposure to the underlying assets of the ABS and, therefore, arguably had decreased incentives to conduct due diligence or otherwise ensure transparency of information about underlying assets for investors in the securitizations. Furthermore, the agencies are of the view that many lenders were incentivized to lower underwriting standards since, once the loans were conveyed in a securitization, the lenders would not be exposed to any underwriting risks.

By requiring securitizers (both sponsors and lenders) to retain some of the credit risk of the underlying ABS assets, Congress and the agencies believe that securitizers would be incentivized to monitor underlying assets, ensure quality, and increase underwriting standards to an acceptable level of risk. The commentary in the Final Rule frequently cites the need to align the incentives of the sponsors of securitizations with those of the investors. However, there are continuing concerns surrounding the effect of the Final Rule on securitizations and general liquidity in the capital markets, particularly for residential mortgage financing.

One of the more interesting and controversial aspects of the Final Rule is that it adopts the CFPB's definition of QM as the definition of QRM. On the one hand, having a unified standard for both mortgage origination and securitization creates less uncertainty in the marketplace and may reduce compliance burdens for financial institutions. Many in the industry advocated for that uniformity. On the other hand, the CFPB does not have rulemaking authority under section 15G, a fact that has troubled some of the agency officials who have been quite vocal about their objections. In addition, the goals and objectives of the CFPB (consumer protection) are different from those of the financial agencies (safety and soundness), which raises the question of whether it makes regulatory sense for definitions of QM and QRM to align given the different goals behind the issuing agencies. In the end, it will be up to the securitization industry to determine if the tradeoff of gaining certainty for having another regulator with influence over securitizations is a beneficial one.

Overall, the long-term economic effects of the Final Rule are unknown. As the agencies note in the Final Rule, securitizations serve an important role in creating liquidity in capital markets, especially the residential mortgage market. However, the agencies note that it is important to balance the goals of risk retention (better alignment of incentives) with the goals of retaining and increasing market liquidity. It is likely that aspects of the Final Rule will need to be periodically reexamined and adjusted to remain flexible as the economy changes.

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16. Final Rule, Section _.7.
17. Final Rule, Section _.10.

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