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FINANCIAL REGULATORY AGENCIES ADOPT FINAL RISK RETENTION RULES, CAUSING CHANGES TO MORTGAGE AND SECURITIZATION PRACTICES

On October 21 and 22, 2014, six federal regulatory agencies jointly adopted a final rule implementing certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) designed to require sponsors of securitization transactions to retain credit risk in those transactions (Final Rule).

The Board of Governors of the Federal Reserve System (Federal Reserve), Department of Housing and Urban Development, Federal Deposit Insurance Corporation (FDIC), Federal Housing Finance Agency (FHFA), Office of the Comptroller of the Currency, and Securities and Exchange Commission (SEC) (collectively referred to as the "federal Agencies") each approved the Final Rule that defines a "qualified residential mortgage" (QRM) and establishes risk retention limits for mortgage originators depending on the characteristics of the mortgage. The Final Rule spans 689 pages, preceded by a 565-page preamble and cost-benefit analysis.

Market participants will certainly identify areas to acclaim and criticize between its adoption and one year from now, when it applies to asset-backed securities (ABS) collateralized by residential mortgages, and two years from now, when it applies to all other classes of ABS.

This publication briefly highlights the Final Rule. Please contact Squire Patton Boggs lawyers with any questions related to the Final Rule and its impact on mortgage and securitization market regulation.

Background

Section 941(b) of the Dodd Frank Act generally requires the securitizer of ABS to retain not less than 5% of the credit risk of the assets collateralizing the asset-backed securities. The statutory provision includes a variety of exemptions from these requirements, including an exemption for ABS that are collateralized exclusively by QRMs. Congress intended to create a framework that would protect investors by requiring originators to retain some "skin in the game," better aligning the interests of those firms and ABS investors.

The Final Rule was preceded by two proposals. In April 2011, the federal Agencies issued their initial proposal. In response to comments received, in September 2013, the federal Agencies issued a second proposal with significant modifications from the April 2011 version. Notably, the requirement that a QRM must include a 20% down-payment was removed in September 2013 and is not included in the Final Rule.

The Final Rule

Framework

The Final Rule explains that, absent an exemption, the sponsor of securitizations that issue ABS interests must retain an economic interest in the credit risk of the securitized assets. Of note, any majority-owned affiliate (other than an issuing entity) of a person (be it a sponsor, originator, originator-seller or third-party purchaser) may acquire and hold the required credit risk retention in securitized assets. However, with multiple sponsors, each sponsor must ensure that at least one of the sponsors of the securitization transaction retains an economic interest in the credit risk of the securitized assets.

QRM Definition and Exemptions

The Final Rule's QRM definition directly adopts the Consumer Financial Protection Bureau's (CFPB) definition of a Qualified Mortgage (QM) allowing for multi-family homes with up to four units, rather than creating or adopting an independent definition. Notably, the QM/QRM definition does not require a minimum down payment, caps debt-to-income ratios at 43%, limits points and fees to 3%, and prohibits negative amortization, interest-only and balloon loans.

The Final Rule clarifies that the full guarantee (for timely payment of principal and interest) by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), while they operate under the conservatorship or receivership of FHFA, satisfies the Dodd-Frank Act risk retention requirements. The Final Rule also provides an exemption from risk retention requirements for certain types of community-focused residential mortgages that are not eligible for QRM status under the Final Rule and are exempt from the ability-to-pay rules under the Truth in Lending Act (TILA). Further, the QRM definition expressly excludes single-borrower or single-credit transactions and open-market collateralized loan obligations from the risk retention requirements. Finally, despite requests by commentators, the Final Rule does not provide a broad exemption for managers of certain collateralized loan obligations.

The Final Rule requires the federal Agencies to review the definition of QRMs four years after the rule takes effect and every five years thereafter. The first scheduled review will take place in 2019, shortly after a scheduled CFPB review of the QM Rule. The definition of QRM will also be reviewable at the request of the federal Agencies. The SEC, in particular, pushed to include scheduled reviews in the Final Rule.

Risk Retention Options

Based on industry calls for flexibility in demonstrating compliance with the risk retention requirement, the Final Rule can be satisfied through risk retention in eligible horizontal interests[1] and eligible vertical interests.[2]

As common rule provision § __.4(a) makes clear, if the sponsor retains only an eligible vertical interest as its required risk retention, the sponsor must retain an eligible vertical interest in a percentage of not less than 5%. If the sponsor retains only an eligible horizontal residual interest as its required risk retention, the amount of the interest must equal at least 5% of the fair value of all ABS interests in the issuing entity issued as a part of the securitization transaction, determined by using a fair value measurement framework under GAAP. If the sponsor retains both an eligible vertical interest and an eligible horizontal residual interest as its required risk retention, the percentage of the fair value of the eligible horizontal residual interest and the percentage of the eligible vertical interest must equal at least 5%. The percentage of the sponsor's eligible vertical interest, eligible horizontal residual interest, or combination thereof retained by the sponsor must be determined as of the closing date of the securitization transaction.

The Final Rule does not require fair value calculations of eligible vertical interest and also adjusts options relating to risk retention for specific asset classes. Finally, sponsors (even with a guarantee from Fannie Mae or Freddie Mac) are prohibited from selling or transferring retained interests for up to two years for ABS, and up to seven years for residential mortgage-backed securities.

Dissent from SEC Commissioners, House Republicans

Five of the federal Agencies approved the Final Rule with little controversy. The Federal Reserve unanimously approved the Final Rule, with Chair Janet Yellen noting that it would "better align the interests of sponsors and investors." FDIC Vice Chairman Thomas M. Hoenig stated that he supports the Final Rule because "lending, investing, and securitizing assets are essential elements of a successful economy." He noted, however, that to promote sustainable growth the Final Rule "must be tempered with sound underwriting standards."

FDIC Director Jeremiah Norton was the only FDIC board member to object to the Final Rule, indicating that "the [federal] Agencies' decision to tie the definition of QRM to QM by operation of law in perpetuity raises a serious question [about an agency delegating its decision-making authority]."

Similarly, the SEC voted 3-2 to adopt the Final Rule. Republican SEC Commissioners Daniel Gallagher and Michael Piwowar criticized the regulation. In particular, Commissioner Gallagher argued that the Final Rule fails to provide a "meaningful, robust standard" for QRMs and that the original April 2011 proposal provided a more appropriate definition. Commissioner Piwowar, an economist, criticized the economic analysis in the Final Rule, noting that the "optimal level of retained risk" had not been determined, and that the federal Agencies were "adopting the imprecise and arbitrary statutory risk retention level of five percent." Commissioner Piwowar also expressed concern that Fannie Mae- and Freddie Mac-sponsored securitizations will never be required to "operate on the same level playing field as private securitizations" because he doubts they will ever be subject to the same retention standards.

Commissioner Gallagher voiced support for pending legislation sponsored by House Financial Services Committee Chairman Jeb Hensarling (R-TX), which would wind down Fannie Mae and Freddie Mac. In a statement, Chairman Hensarling called for the repeal of the Dodd-Frank Act, including the risk retention provisions, arguing for private market solutions over statutory mandates.

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[1]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 this 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 REMIC residual interest, has the most subordinated claim to payments of both principal and interest by the issuing entity.

[2]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 proportion of each such class.

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