



Regulators Finalize Risk-Retention Rule for ABS

Federal regulators recently published a final risk-retention rule (Final Rule) that requires sponsors of securitized financial assets to retain a minimum of five percent of the credit risk unless certain exceptions are met.¹ The Final Rule implements Section 941 of the Dodd-Frank Act, which is intended to encourage sound underwriting practices and to better align the interests of securitizers with investors in both public and private transactions.²

Key Facts

The Final Rule:

- Requires sponsors of asset-backed securities (ABS) and residential mortgage-backed securities (RMBS) to retain a minimum of five percent of the issuer's credit risk unless certain exceptions are met;
- Exempts securitizations of Qualified Residential Mortgages (QRM) from the risk-retention requirement; and
- Provides sponsors with risk-retention options that give them flexibility in satisfying the requirement.

This Final Rule will be effective:

- One year after the date of publication in the Federal Register with respect to ABS collateralized by residential mortgages; and
- Two years after publication in the Federal Register with respect to all other classes of ABS.

Key Impacts

- Sponsors must retain additional risk for certain securitized asset classes, face increased complexity related to a myriad of additional rules, and comply with increased disclosure requirements related to fair value measurements.
- One of the most significant changes from the Re-proposal was the removal of the minimum down payment requirement for QRMs, settling one of the most contentious industry debates surrounding risk retention.

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¹ Federal regulatory agencies include the Office of the Comptroller of the Currency, the Federal Reserve, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Department of Housing and Urban Development, and the Securities and Exchange Commission. SEC Final Rule No. 34-73407, Credit Risk Retention, is available at www.sec.gov.

² The Dodd-Frank Wall Street Reform and Consumer Protection Act is available at http://docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf.

Summary of Final Rule

The Final Rule is substantially similar to the rule that was re-proposed in August 2013.³ The following tables summarize the Final Rule's significant provisions and the provisions that were not included in the Final Rule.

Provisions Included in the Final Rule	
Minimum Risk-Retention Requirement	Generally not less than 5 percent credit risk for securitization transactions that are within the scope of Section 15G of the Securities Exchange Act of 1934.
Qualified Residential Mortgage	Securitizations composed entirely of QRM are exempt from the risk-retention requirement. The definition of a QRM aligns with the underwriting requirements for a qualified mortgage adopted by the Consumer Financial Protection Bureau (CFPB). This definition does not contain down payment requirements, a loan-to-value (LTV) ratio, or credit-history reporting. However, QRM does require verification of the borrower's income and assets, and a total debt-to-income ratio that does not exceed 43 percent.
U.S. Agency and Government-Sponsored Entities (GSEs)	Securitizations of assets that are issued, insured, or guaranteed by the United States or any of its agencies (e.g., Ginnie Mae) are exempt from the requirement. The guarantee by Fannie Mae or Freddie Mac meets the risk-retention requirements as long as they are operating under the conservatorship of the Federal Housing Finance Agency and receiving capital support from the U.S. government.

³ The risk retention rule was initially proposed by the Joint Regulators in March 2011 (the Original Rule), and re-proposed in August 2013 (the Re-proposed Rule).

Risk-Retention Options	The menu of risk-retention options includes vertical, horizontal, or some combination of both (an “L-shaped combination”). Alternatives specific to revolving pool securitizations, collateralized mortgage-backed securities (CMBS), collateralized loan obligations (CLO), asset-backed commercial paper (ABCP), GSEs, and municipal bond repackagings also are provided.
Holding Retained Risk	The credit risk retained by the sponsor may be held through majority-owned affiliates as defined by U.S. GAAP.
Fair Value	Horizontal risk retention is measured at fair value while vertical risk retention is measured based on the par value at the closing date. Disclosure of fair value assumptions and methodologies is required both before and after the sale for the horizontal option and is measured under U.S. GAAP.
Hedging, Financing, and Transfers of Retained Interests	The Final Rule prohibits the sponsor from hedging or otherwise transferring its retained interest prior to the sunset date.
CLO Managers	CLO managers have been scoped into the definition of securitizer with no structural exemptions or third-party purchaser options as suggested by market participants.

Provisions Not Included in the Final Rule	
Cash Flow Restriction	The proposed payment restriction to the sponsor of horizontal interests (such that they could not receive cash faster than principal amortization of the whole transaction) was removed. This provision would have had a big impact on CLOs and CMBS given current market practices.
Fair Value of Vertical Interests	Vertical interests will be measured using the par value rather than fair value, which was included in the Re-proposed Rule.

Premium Capture Rule	The Original Rule would have required excess interests to be retained in the deal until other interests are paid.
Representative Sample Option	The option to satisfy the risk-retention requirement by the sponsor holding a representative sample of five percent of the assets was omitted.

Qualified Residential Mortgage Exemption

The Dodd-Frank Act exempts ABS collateralized solely by QRM from the risk-retention requirements. The Final Rule defines QRM to align with the underwriting requirements for qualified mortgages that were adopted by the CFPB. For a loan to be a qualified mortgage, it must be currently performing when the securitization transaction closes and include:

- Regular periodic payments that are substantially equal;
- No negative amortization, interest only, or balloon payment features;
- A maximum term of 30 years;
- Total points and fees that do not exceed three percent of the total loan amount, or the applicable amounts specified in the Final Ability to Repay Rule for small loans up to \$100,000; and
- Payments that are underwritten using the maximum interest rate that may apply during the first five years must include consideration and verification of the consumer's income and assets and a total debt-to-income ratio that does not exceed 43 percent.

The depositor for the ABS also must certify that the internal supervisory controls are effective. If, after closing the securitization transaction, it is determined that one or more QRM loans did not meet the QRM definition, the sponsor must repurchase them and promptly notify all ABS investors.

Other Exemptions

The Final Rule exempts ABS collateralized by commercial loans, commercial mortgages, and automobile loans that meet certain underwriting standards.

- **Commercial Loans.** Qualifying loans need to satisfy criteria related to the total liabilities ratio, leverage ratio, debt service coverage ratio, amortization schedule, length of loan, and related debt covenants.
- **Commercial Mortgages.** Qualifying loans need to satisfy criteria related to the borrower's ability to repay the loan, the LTV ratio, the value of the collateral, and its risk management and monitoring.
- **Automobile Loans.** Qualifying loans need to satisfy criteria related to the borrower's ability to repay the loan, loan terms (i.e., fixed and maximum five-year maturity date), borrower's credit history, and the LTV ratio.

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The QRM repurchase considerations also apply to commercial loans, commercial mortgages, and automobile loans if they are subsequently determined to not have met the exemption criteria outlined above.

The Final Rule permits pools of qualifying commercial, commercial real estate, and automobile loans to have zero percent risk retention if the pools are 100 percent qualifying loans. For pools comprised of a mix of qualifying and non-qualifying loans (but not more than 50 percent non-qualifying) the blended pools would be eligible for reduced risk retention. However, the retention cannot be less than two-and-a-half percent and would be based on the proportion of qualifying and non-qualifying loans.

Risk retention will not apply to federally insured or guaranteed residential, multifamily, and health care mortgage loan assets; securitizations of assets that are issued, insured, or guaranteed by the United States or any of its agencies (e.g., Ginnie Mae); and certain re-securitization transactions. The Final Rule provides exemptions for government-regulated utility securitizations and seasoned loan securitizations and continues to provide safe harbor for some foreign transactions.

Risk Retention

When developing the risk-retention requirements, the regulators considered how sponsors have historically retained risk in securitization transactions. The risk retention options included in the Final Rule are intended to give sponsors the flexibility to meet investors' expectations (which vary by asset type) while complying with the Dodd-Frank Act. Generally, the Final Rule requires the sponsor (or any of its majority-owned affiliates) to retain an economic interest equal to at least five percent of the aggregate credit risk of the ABS issued. Unless specifically prohibited, sponsors may choose any of the standard risk retention or transaction specific risk-retention options.

Risk-Retention Options	Final Rule
Standard Risk Retention	Permits vertical risk retention, horizontal risk retention, and their combination.
Revolving Pool Securitizations (Seller's Interest)	Permits the use of seller's interest to reflect market practices for pools of revolving assets (e.g., credit card receivables).
ABCP Conduits	Permits each originator-seller that transfers assets to eligible ABCP conduits to satisfy the risk-retention requirements.
CMBS	Permits one or two qualified third-party investors who absorb the first losses (B-piece) to satisfy the risk-retention requirements.

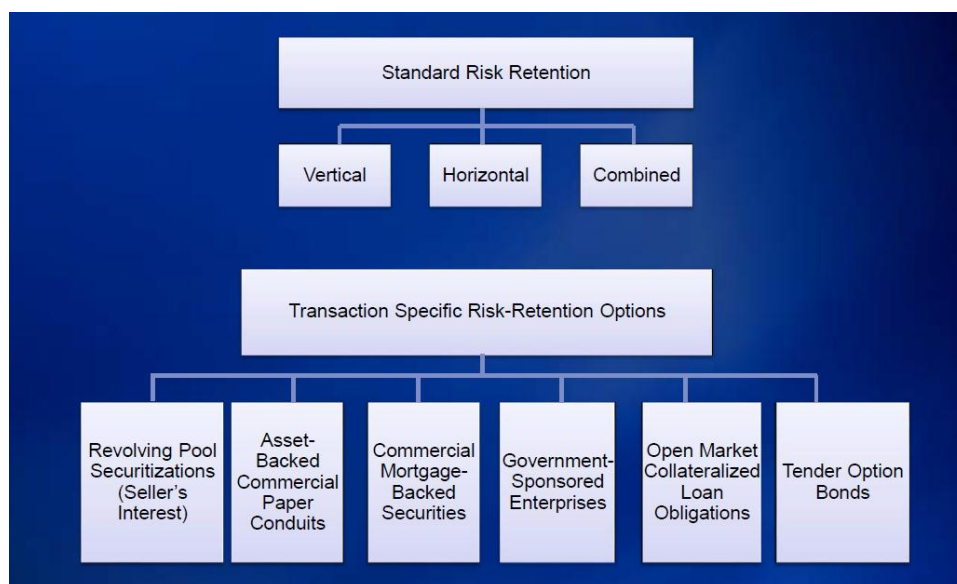
Risk-Retention Options	Final Rule
GSE	Continues to recognize the guarantee provided by Fannie Mae and Freddie Mac while they are in conservatorship or receivership and have capital support from the U.S. government.
CLO	Permits the arrangers of loans purchased by open market CLOs to fulfill the risk-retention requirement.
Municipal Bond Repackaging Securitizations	Permits certain tender option bonds to qualify for special options that may be combined to satisfy risk-retention requirements.

Horizontal. A sponsor satisfies the risk-retention requirements by retaining an eligible horizontal residual interest that is equal to a minimum of five percent of the fair value of all ABS interests at issuance. The horizontal residual interest exposes the sponsor to the first dollar of loss. As an alternative, the sponsor could establish a cash reserve account with a trustee comprised of five percent of the fair value of all ABS issued. The cash reserve account would be exposed to the same amount and type of first-loss credit risk on the underlying assets as if the sponsor held an eligible horizontal residual interest.

Vertical. The sponsor retains a minimum of five percent of each class of ABS issued in connection with a securitization or a single eligible vertical security measured at the par value. For example, if a securitization was comprised of three tranches (e.g., AAA-rated senior tranche, BBB-rated subordinate tranche, and CCC-rated retained interest), the sponsor would be required to retain at least five percent of each tranche. As an alternative to retaining multiple interests, the Final Rule permits a single eligible vertical security that is an ABS to pay interest that gives the securitizer a specific percentage of the principal and interest paid on each class of the ABS interest.

Combined or L-shaped. This combined risk-retention approach allows a sponsor to hold any combination of eligible horizontal or eligible vertical interests equal to no less than five percent of the fair value of all ABS interests.

Transaction Specific Risk-Retention Options



Revolving Pool Securitizations (Seller's Interest). Certain securitization structures are backed by a pool of revolving assets (e.g., credit card receivables) and permit the issuance of multiple ABS collateralized by the pool. The sponsor generally holds a seller's interest in the trust, which represents a pari passu or subordinated interest (with the ABS investors) in the underlying pool of receivables. Because the seller's interest exposes its holders to the credit risk of the receivables pool, the Final Rule permits the sponsor to meet the risk-retention requirements by retaining a seller's interest greater than or equal to five percent of the unpaid principal balance of the outstanding ABS interests held by investors, or by combination of the seller's interest with other risk retention.

ABCP Conduits. Eligible ABCP entities issue short-term obligations with maturities of 397 days or less and have a liquidity support arrangement with the sponsoring entity (typically a regulated financial institution) that requires the sponsor to provide funds to meet cash shortfalls. The sponsor of an eligible ABCP conduit would meet the risk retention rule if each entity selling assets or the majority-owned originator-seller affiliates retained the same amount and type of credit risk that would be required under the standard risk-retention requirements or revolving asset master trust risk retention.

This option is not available to entities or ABCP programs that operate as a structured investment vehicle or securities arbitrage program. The sponsor of the ABCP conduit still has certain obligations because of its key role in organizing and operating an eligible ABCP conduit, including being responsible for all participating entities' compliance with the risk-retention requirements.

CMBS. If certain conditions are satisfied, the Final Rule allows the risk-retention requirements to be met when up to two third-party investors (B-piece buyers) of commercial mortgage securitizations retain the eligible horizontal residual interest. The conditions include requiring that the third-party investors pay cash for the residual interest and perform due diligence on all individual assets in the

securitization. The CMBS transaction documents must mandate the appointment of an independent operating advisor.

The risk-retention requirements could be met through the third-party investors' interests or a combination of their interests with the sponsor's interest.

GSEs. The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) receive capital support from the United States, which guarantees the timely payment of the principal and interest of ABS that they issue. The guarantee would meet the risk-retention requirements for any mortgage-backed securities that Fannie Mae or Freddie Mac issue. These risk-retention requirements would continue to be met while the GSE (or any successors) are operating under the conservatorship of the Federal Housing Finance Agency and receiving capital support from the U.S. government.

Open Market Collateralized Loan Obligation. An open market CLO acquires servicing assets and senior, secured syndicated loans directly from sellers in the open market. It holds less than 50 percent of its assets by aggregate outstanding principal amount in loans syndicated by lead arrangers that are affiliates of the CLO or originated by parties that are affiliates of the CLO.

For some open market CLOs, the sponsor satisfies the risk-retention requirements through the lead arranger retaining credit risk. The CLOs' assets consist solely of CLO-eligible loan tranches or servicing assets and must meet other specific conditions. The lead arranger of loans purchased by a CLO-eligible loan tranche retains at origination of each syndicated loan at least five percent of the face amount of the term loan tranche. The lead arranger retains the risk until the earliest of the repayment, maturity, involuntary and unscheduled acceleration, payment default, or bankruptcy default of the CLO-eligible loan tranche.

Tender Option Bonds (TOB). This transaction consists of the deposit of a single, highly rated, long-term municipal bond into a trust and the issuance of a floating rate puttable security (floaters) and an inverse floating rate security (residual). The holders of the floaters have the right to put their interests for purchase at par. The put right is supported by a liquidity facility provided by a regulated liquidity provider.

A sponsor of a qualified TOB satisfies its risk-retention requirements by:

- Retaining an interest that meets the requirement of an eligible horizontal residual interest, but that upon the occurrence of a tender option termination event meets the requirements of an eligible vertical interest;⁴ or
- Holding municipal securities from the same issuance of municipal securities deposited in the qualified TOB entity with a face value equal to five percent of the face value of the municipal securities deposited in the qualified TOB entity.

Under the Final Rule, a combination of these two options also may be used to satisfy the risk-retention requirement.

⁴ The tender option termination event is defined in Section 4.01(5) of the IRS Revenue Procedure 2003-84.

Hedging, Financing, and Transfers of Retained Interests

Specified time periods when restrictions on hedging and transfers of retained interests will expire were added to the Final Rule. The regulators concluded that the primary purpose of risk retention — sound underwriting — is less likely to be advanced by risk-retention requirements issued after delinquencies have peaked.

Asset Class	Hedging and Transfer Restriction Expiration Periods
General Rule	<p>Transfer and hedging restrictions expire on the later of:</p> <ul style="list-style-type: none"> • Two years after the closing date; • The date the unpaid principal <i>balance</i> of the securitized assets has been reduced to 33 percent of the unpaid principal balance as of the closing date; or • The date the unpaid principal <i>obligation</i> has been reduced to 33 percent of the unpaid principal obligations as of the closing date.
RMBS	<p>Transfer and hedging restrictions expire on the later of:</p> <ul style="list-style-type: none"> • Five years after the closing date; or • The date the unpaid principal balance of the residential mortgages has been reduced to 25 percent of the unpaid principal balance as of the closing date, but no later than seven years after the closing date.
CMBS	<p>The sponsor or third-party initial purchaser may transfer its retained interest after five years from the closing date if the transferee satisfies certain requirements.</p>

Transfers are permitted in situations where the transferee is a majority-owned affiliate (i.e., an entity that directly or indirectly has majority control, is majority controlled by, or is under common control of the sponsor).

Because the hedging prohibitions are focused on the credit risk associated with the interests or assets that the sponsor is required to retain, the sponsor or any of its affiliates would be permitted to enter into hedges that are not materially related to the credit risk of the retained interests or assets. For example, hedges related to overall market movements in interest rates, foreign exchange rates, and home prices, among others, are allowed. Hedges tied to ABS backed by

similar assets that are securitized by the same sponsor also are allowed if they are not materially related to the assets the sponsor is required to retain.

The Final Rule also permits hedges based on indices that include one or more tranches from a sponsor's ABS transactions. However, these hedges are not permitted if any class of the ABS represents more than 10 percent of the dollar-weighted average of all instruments included in the index. Hedges also are not permitted if all classes of ABS represent more than 20 percent of the dollar-weighted average of all instruments included in the index. For example, holding a security tied to the return of the Markit's ABX indices of subprime mortgages is permitted as long as these percentages are met.

However, a sponsor and its affiliates are prohibited from pledging as collateral any interest or asset that the sponsor would be required to retain, unless the obligation is with full recourse to the sponsor or its affiliates.

Disclosure Requirements and Fair Value

With respect to horizontal retained interests, the sponsor must disclose the following:

- Within a reasonable period of time prior to the sale of the ABS interests:
 - The fair value of the horizontal retained interest that it expects to retain at the closing of the securitization transaction. In the selected structure, if the tranche sizes or rates have not been determined, then a range of fair values disclosed is permitted if that methodology is also disclosed;
 - A description of the material terms of the horizontal retained interest;
 - A description of the valuation methodology used to calculate the value of the ABS interests and the horizontal retained interest; and
 - All key inputs and assumptions or a comprehensive description of those assumptions that were used in measuring the estimated total fair value or range of fair values of all classes of ABS interests, including the horizontal residual interest. This would include, but not be limited to:
 - Discount rates;
 - Loss given default (recovery);
 - Prepayment rates;
 - Default rates;
 - Lag time between default and recovery;
 - The basis of forward interest rates used; and
 - Descriptions of all inputs and assumptions that would have a material impact on the fair value calculation or ability to evaluate the fair value calculation. This also would include a summary description of reference data and other historical data used to develop key inputs and assumptions.
- Within a reasonable period of time after closing:
 - The fair value of horizontal retained interest that the sponsor retained;

- The fair value of horizontal retained interest that the sponsor is required to retain; and
- To the extent the valuation methodology and key inputs were used in calculating the fair value or range of fair value prior to the sale materially differ from those used to calculate the fair value at the time of closing, a description of those differences.

Potential Implications

The Final Rule applies to virtually all securitizations, including public and private transactions. However the impact to sponsors will vary, depending upon the asset class and collateral composition. Sponsors of securitizations may want to consider a number of potential implications.

- **Additional Risk Retention.** In many market transactions, risk retention already takes place. Sponsors may want to analyze how significant the incremental risk-retention requirements might be. For example, incremental risk-retention requirements will require incremental capital, which should be considered when evaluating the overall competitiveness of securitizations as a funding source. For bank sponsors, the Final Rule's impact on regulatory capital should be evaluated in consideration of Basel III and its expected changes.⁵
- **Potential Benefits.** Companies may want to analyze the potential benefits that the Final Rule might create such as improved investor confidence in the securitization markets. Risk retention has been one of the major uncertainties in the private-label RMBS market, and this may be one additional step that will pave the way to private capital returning to that market, which has largely been dormant since the 2008-2009 financial crisis.
- **Additional Cost from Complexity.** Incremental operational costs may be incurred from implementing the Final Rule, including legal, personnel, and compliance costs. For example, there likely will be incremental costs associated with the depositor certifying that it evaluated the effectiveness of internal supervisory controls to ensure that all of the assets collateralizing ABS are QRMs.
- **Business Impact.** Sponsors may structure transactions differently under the Final Rule and may want to evaluate any associated business requirements. Concerns have been raised about the possibility of an unlevel playing field resulting from special status being afforded to transactions by GSEs. Additionally, some asset classes, like CLOs, may experience fewer market participants who are able to transact given the additional capital requirements to retain the risk. The additional capital will increase the cost of funding the commercial loans and may make other forms of funding more attractive compared to CLOs.

⁵ Basel III is a global, voluntary regulatory standard that addresses bank capital adequacy, stress testing, and market liquidity risk.

- **Accounting and Financial Reporting.** The financial reporting impact of the planned method of complying with the Final Rule should be evaluated. For example, a sponsor that chooses to retain risk horizontally may be required to consolidate the assets and liabilities of the securitizations. Conversely, if a sponsor retains only a five percent vertical risk, and holds no other investments or other forms of variable interests in the securitization other than an at-market servicing arrangement, then consolidation is not likely to be required and derecognition of the securitized assets is more likely to be achieved.

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