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"QM Equals QRM" ... CFPB Paves the Way for Key Exemption to Risk Retention Rule

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INTRODUCTION

In an unprecedented ceding of regulatory authority, six federal agencies, the Board of Governors of the Federal Reserve System, Department of Housing and Urban Development, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Office of the Comptroller of the Currency, and Securities and Exchange Commission (the "Agencies"), largely relinquished their jurisdiction to the Bureau of Consumer Financial Protection ("CFPB") on determining what is a "qualified residential mortgage" ("QRM") under the long-awaited securitization risk retention rule required by Section 941 of the Dodd-Frank Act ("DFA"). A critical exemption to the final risk retention rule, commonly referred to as the "skin in the game" requirement, is the QRM provision, which the Agencies have tied directly to the CFPB's "qualified mortgage" ("QM") rule, a safe harbor to the so-called "ability to pay" requirement implemented by the CFPB under Regulation Z, as amended by DFA §§ 1411 and 1412. In effect, the Agencies have deferred to the CFPB's determination of what qualifies as a QM under Regulation Z in defining what is a QRM that is exempt from the risk retention rule.

Highly anticipated because of its impact on the mortgage markets and potential to jump start the private mortgage-backed securitization markets, the final risk retention rule comes after the issuance of two proposed rules, the first issued in April 2011 (the "original proposal") and the second in August 2013 (the "revised proposal"). DFA § 941, which amended Section 15G of the Securities Exchange Act of 1934, is intended to address problems in the securitization markets by requiring that securitizers generally retain a five percent economic interest—which may be structured in several ways, as described below—in the credit risk of the assets they securitize, *i.e.*, that securitizers retain "skin in the game." The final rule generally mirrors the revised proposal, with some modifications. While providing some certainty to the securitization markets, the new rule raises numerous other compliance and deal-related issues. For example, it remains to be seen whether the Agencies will speak with one voice in interpreting the new rules, the extent to which the QM rule will influence the QRM exemption, and the manner in which the risk retention requirement will be applied across different types of securitizations.

SUMMARY OF THE FINAL RULE

In issuing the final rule, the Agencies took into account many of the comments received on the original and revised proposals, but only a few notable changes to the revised proposal are evident in the final rule. For additional background information regarding the original proposal, click here; for

information on the revised proposal, click here. Among the noteworthy developments of the final rule are the following:

- The Agencies' decision to simplify the scope of the definition of a QRM to align with the separate but similar definition of a QM,[1] which was adopted by the CFPB, an agency not participating in the issuance of the final rule;
- The originally proposed five percent risk retention requirement was ultimately retained in the final rule;
- A requirement that risk retention be based on the fair value of the assets underlying the securitization;
- The application of the risk retention rule to open market collateralized loan obligations ("CLOs"); and
- The presence of several notable exemptions to the risk retention requirement.

These provisions are discussed in greater detail below.

A. General Risk Retention Requirement

The Agencies adopted a five percent minimum risk retention requirement, as originally proposed, and did not adopt variations based on the quality or class of assets to be securitized. As such, the final rule applies a minimum five percent base risk retention requirement to all securitization transactions within the scope of section 15G, unless an exemption applies. For securitizations where two or more entities meet the definition of sponsor of the securitization, only one of the sponsors is required to comply with the rule. The rule does not prohibit parties from agreeing to a higher than five percent risk retention requirement, or from allowing multiple sponsors from retaining credit risk.

A sponsor may reduce its required risk retention obligation in a transaction by the portion of risk retention assumed by one or more of the originators of the securitized assets. In this regard, the amount of the retention interest held by each originator is required to be at least 20 percent, but no more than the percentage of assets it originated.

Additionally, there are hedging, transfer, and financing restrictions on the credit risk retained by a sponsor. As with the previous proposals, a sponsor is prohibited from: (i) transferring any interest or assets that it was required to retain under the rule to any person other than a majority-owned affiliate; (ii) hedging the credit risk the sponsor is required to retain under the rule, unless the hedge positions are expressly permitted or not materially related to the credit risk of the particular asset-backed security ("ABS") interests or exposures required to be retained by the sponsor; or (iii) pledging as collateral for any obligation any interest or asset that the sponsor is required to retain, unless the pledge collateralizes an obligation with full recourse to the sponsor or a consolidated affiliate. As in the proposed rules, the final rule retains a sunset on hedging and transfer restrictions.

B. Permissible Forms of Risk Retention—Menu of Options

The "menu of options" approach was designed to take into account the heterogeneity of securitization markets and practices and to reduce the potential for the proposed rules to negatively affect the availability and costs of credit to consumers and businesses. The Agencies adopted the menu of options largely as proposed, declining to recognize legal forms of risk retention under the rule beyond

ABS interest by including *pari passu* participation interests, subordinated participation interests, *pari passu* companion notes, or subordinated companion notes.

1. Standard Risk Retention

Consistent with the proposed rule, the final rule allows a sponsor to satisfy its risk retention obligation by retaining an eligible vertical interest,[2] an eligible horizontal residual interest,[3] or any combination thereof, as long as the combination of percentages equal no less than five percent of the aggregate securitization interest.

The rule allows a sponsor to satisfy its risk retention obligation under the vertical option by retaining a portion of each class of the ABS interests issued in the transaction or a single vertical security which represents an interest in each class of the ABS interests. This precludes a sponsor from claiming risk retention credit for any proportional interest in a class that is not the same across all classes.

The rule also allows a sponsor to satisfy its obligation exclusively through the horizontal option by retaining a first loss eligible horizontal residual interest in the issuing entity in an amount of no less than five percent of the fair value of all ABS interests in the issuing entity that are part of the securitization transaction. The rule imposes additional restrictions on what constitutes an eligible horizontal residual interest.

With regard to measuring risk retention, the Agencies have adopted a fair value framework substantially similar to the revised proposal for calculating eligible horizontal residual interests in the final rule. The rule allows sponsors, for disclosures provided prior to sale, to disclose the sponsor's determination of a range of fair values for the eligible horizontal residual interest that the sponsor expects to retain at the close of the securitization transaction. A sponsor may provide a range of fair values only if the specific series, sizes, or interest rates of each tranche of the transaction are not available, but this range of values must be based on a range of bona fide estimates or specified prices, sizes, or interest rates for each tranche. The fair value measurement does not apply to eligible vertical interests because such measurement is not necessary to ensure that the sponsor has retained five percent of the credit risk of the ABS interests issued.

The final rule omits the restrictions on projected cash flow to an eligible horizontal residual interest that were contained in the proposed rule because such restrictions pose significant risk of unintended consequences. The Agencies left the door open to modifications, however, noting that if they observe that either the assumptions or methodologies used to calculate the fair value of horizontal risk retention or the structuring of securitization transactions tends to undermine the ability of risk retention to align the interests of sponsors and investors, the Agencies will consider whether the rule should be modified to address those issues.

2. Master Trusts: Revolving Pool Securitizations

The Agencies also revised the master trust option in the final rule to make the option available to more commercial firms that currently rely on revolving pool securitizations as a component of their funding base. Investors in the various series of ABS interests issued by a master trust have claims on the remaining principal and interest or finance charge payments as the source of repayment for the ABS interests they purchased from the master trust. The seller's interest in these structures is generally *pari passu* with the investor ABS interests, resulting in the sponsor incurring a pro rata share of credit losses on securitized assets, in a percentage amount equal to the percentage amount of the seller's interest as calculated under the terms of the transaction documents. Under the final rule,

sponsors must maintain the size of the seller's interest position if the existing pool is diminished by charge-offs exceeding expected loss rates.

The Agencies also adopted a change requested by commenters to accommodate other revolving pool securitizations that are common in the market and rely on over-collateralization in a different manner, which varies between asset classes. Specifically, the Agencies revised the distribution language in the definition of seller's interest to include seller's interests that are *pari passu* with each series of investor ABS interests, or partially or fully subordinated to one or more series in identical or varying amounts with respect to the allocation of all distributions and losses on the securitized assets.

3. Representative Sample

The original proposal would have allowed a sponsor to satisfy its risk retention requirement by retaining ownership of a randomly selected representative sample of assets. Due to concerns regarding the practicality of obtaining a truly representative sample, including the risk that sponsors would be able to "cherry pick" assets favorable to them, as well as other similar risks, the final rule does not include a representative sample option.

4. Asset-Backed Commercial Paper ("ABCP") Conduits

The final rule includes a specific option for ABCP securitization transactions that retains the basic structure of the re-proposed ABCP option, with modifications. Specifically, the rule provides that an eligible ABCP conduit sponsor will satisfy the risk retention requirement if, for each ABS interest the ABCP conduit acquires from an intermediate special purpose vehicle ("SPV"), the intermediate SPV's originator-seller retains an economic interest in the credit risk of the collateralizing assets using either standard risk retention or the revolving pool securitization option. The originator-seller will still be considered the sponsor of the ABS issued by an intermediate SPV and will therefore also be required to retain an economic interest in the credit risk. The sponsor of an ABCP conduit, however, is not limited to using the ABCP option to satisfy its risk retention requirements; the sponsor may rely on any risk retention option, provided it meets the criteria for such option.

The Agencies also revised the definition of "eligible ABCP conduit" in the final rule to accommodate certain business combinations and to clarify the requirements for the types of assets that can be acquired by an eligible ABCP conduit.

5. Commercial Mortgage-Backed Securities ("CMBS")

As set forth in the revised proposal, a sponsor of ABS interests that is collateralized by commercial real estate ("CRE") loans can meet its risk retention requirements if third-party purchasers (so-called "B-piece buyers") acquire eligible horizontal residual interests in the issuing entity. Up to two B-piece purchasers can fulfill the risk retention requirement for a single transaction, and there are no specific qualifying criteria for B-piece purchasers. However, the purchasers must be independent from originators of more than 10 percent of the securitized assets.

As with the revised proposal, all CMBS transactions that use the third-party purchaser option must appoint an Operating Advisor that is not affiliated with other parties to the securitization transaction. Additionally, the final rule permits the transfer of the B-piece after a five-year period. The only substantive change in the final rule from the revised proposal is that it allows the risk retention obligation to terminate once all of the loans in a CMBS transaction are fully defeased.

6. Government-Sponsored Enterprises ("GSEs")

As with the revised proposal, the full guarantee (for timely payment of principal and interest) by the GSEs (or a similar limited-life entity) while they operate under the conservatorship or receivership of FHFA with capital support from the United States satisfies the risk retention requirements with respect to mortgage-backed securities ("MBS") issued by the GSEs.

7. Open Market Collateralized Loan Obligations

The final rule applies risk retention requirements to open market CLOs as well as balance sheet CLOs. CLO managers are deemed to be "securitizers" within the meaning of 15G, and a CLO is deemed to be an ABS transaction for purposes of the final rule. As such, open market CLO managers will be required to satisfy the risk retention requirements.

The application of the final rule to open market CLOs is controversial, as many commenters suggested that the rule should not be applied to open market CLOs because the structural and other characteristics of open market CLOs make risk retention unnecessary. The application of the final rule to open market CLOs could potentially lead to a significant reduction in CLO offerings and a corresponding reduction in credit to commercial borrowers. The Agencies acknowledge the potential adverse impact on CLOs under the final rule, but also observed that the market will likely adjust to the rule and lending will continue at a healthy rate.

8. Municipal Bond "Repackaging" Securitizations

The final rule does not provide an exemption from risk retention requirements for sponsors of issuing entities with respect to tender option bonds. Therefore, such sponsors are subject to the risk retention requirement. Consistent with the treatment of sponsors of other ABS, the holder of risk retention in connection with the issuance of tender option bonds may divide the ABS interests or tax-exempt municipal securities required to be retained under the final rule among its majority-owned affiliates, but not among unrelated entities.

The tender option bond option is narrowly constructed. Sponsors of issuances of ABS that are collateralized by assets other than tax-exempt municipal securities with the same municipal issuer and the same underlying obligor or source of payment are not eligible for the municipal bond repackaging exemption.

C. General Exemptions

Section 15G requires the Agencies to provide a total or partial exemption from the risk retention requirements for certain types of ABS or securitization transactions. The exemptions adopted in the final rule, which are substantially similar to the exemptions set forth in the proposed rules, include:

- Federally insured or guaranteed residential, multifamily, and health-care mortgage loan assets;
- Securitizations of assets issued, insured, or guaranteed by the U.S. or any agency of the U.S. and other exemptions;
- Federal Family Education Loan Program and certain other student loan securitizations;
- Certain public utility securitizations;

- Seasoned loan securitizations;
- Securitizations sponsored by the FDIC, acting as conservator or receiver;
- Certain resecuritization transactions, including "pass-through" resecuritizations; and
- Certain other exemptions, including legacy loan securitizations, corporate debt repackagings, and securitizations of servicer advance receivables.

D. Reduced Risk Retention Requirements and Underwriting Standards for ABS Interests Collateralized by Qualifying Commercial, CRE, or Automobile Loans

There continues to be an exemption from the rule for securitizations consisting solely of commercial, CRE, and automobile loans that meet specific proposed underwriting standards (qualifying assets). Sponsors are permitted to commingle qualifying and non-qualifying assets of a similar type to receive up to a 50 percent reduction in the minimum required risk retention amount. There are, however, disclosure and certification requirements, as set forth in the revised proposal, that attach to the availability of this exemption.

The Agencies adopted the qualifying commercial and automobile loan standards as proposed, and adopted some modifications with respect to the definition and qualification of CRE loans.

E. Qualified Residential Mortgages

A highly-anticipated provision of the final rule is the exemption for QRMs. As highlighted above, the Agencies tied the definition of a QRM to the CFPB's QM definition as defined in section 129C of TILA and the regulations thereunder, promulgated by the CFPB. Interestingly, the FDIC was not unanimous in its decision to link the definition of QRM to QM. In this regard, FDIC Board Member Jeremiah Norton issued a statement critical of the "QM equals QRM" approach and was particularly concerned with the Agencies' decision to "subdelegate" the authority to define a QRM to the CFPB.[4]

Under the definition in the final rule, a QRM is a loan that is a "covered transaction" that meets the general definition of a QM promulgated by the CFPB, under which a loan must have:

- Regular periodic payments that are substantially equal;
- No negative amortization, interest only, or balloon features;
- A maximum loan term of 30 years;
- Total points and fees that do not exceed 3 percent of the total loan amount, or the applicable amounts specified for small loans up to $100,000;
- Payments underwritten using the maximum interest rate that may apply during the first five years after the date on which the first regular periodic payment is due;
- Consideration and verification of the consumer's income and assets, including employment status if relied upon, and current debt obligations, mortgage-related obligations, alimony and child support; and
- Total DTI ratio that does not exceed 43 percent.[5]

While the QRM definition is not a departure from the revised proposal, its final form represents a victory for the mortgage lending and securitization industry, seeking uniformity in mortgage-related rules, as the original proposal had also required loans subject to the QRM exemption to be limited to loans where a borrower made a down payment of 20 percent or more on the mortgaged property.

The QRM definition in the final rule also includes any closed-end loan secured by any dwelling; however, loans exempt from the ability-to-repay requirements are not included, as the definition of a QRM cannot be broader than a QM. The definition of a QRM also includes loans that meet one of the special types of QMs. In order for a QRM to qualify for the exemption, the rule includes evaluation and certification conditions, as well as a repurchase obligation, similar to the revised proposal.

In addition, the final rule provides an exemption for certain mortgage loans secured by three- to four-unit residential properties that meet the criteria for a QM other than being a consumer credit, as well as an exemption to permit sponsors to blend these loans with QRMs. The rule also includes exemptions for certain types of community-focused residential mortgages not eligible for QRM status, similar to the exemptions provided from Regulation Z's ability-to-repay requirement.

Notwithstanding the "QM equals QRM" approach, the QRM standard remains subject to change. In this regard, the Agencies have indicated their intent to periodically review the advantages and disadvantages of aligning the QRM and QM definitions as the market evolves.

ACTION PLAN

Securitizers of assets, including bank and non-bank mortgage loan originators, should solidify an action plan regarding the modifications in the final rule and implementation of the various key exemptions. Industry participants should continue to review their current underwriting, sales, and securitization practices, as well as the wide range of regulatory implications in light of the final rule.

Additionally, participants should continue to monitor the definition of a QRM, which will be reviewed again by the Agencies within four years, and at least every five years thereafter. In the interim, participants must keep abreast of CFPB developments involving the QM definition, as a change in that rule will impact the QRM exemption prior to the formal four-year review due to the six adopting agencies' linkage to the CFPB's QM rule.

Finally, risk retention is a very fluid area, particularly given that seven federal agencies may influence the final rule that may not be at all obvious, and yet that may have a significant impact on how risk retention evolves with respect to different types of securitizations. Thus, an important action item is remaining abreast of how new structures may be developed upon the effective date of the final rule, one year from publication of the final rule in the Federal Register for residential MBSs and two years after publication for all other types of securitizations.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[1] QM is defined pursuant to section 129C of the Truth in Lending Act ("TILA") and its implementing regulations. 15 U.S.C. 1639c; 12 C.F.R. Part 1026.

[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.

[3] "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.

[4] *See* Statement of FDIC Director Jeremiah O. Norton, available at https://www.fdic.gov/news/news/speeches/spoct2114c.html?source=govdelivery&utm_medium=email&utm_source=govdelivery.

[5] *See* 12 C.F.R. § 1026.43(e).