COPUBLISHED COMMENTARY

ALL I WANT FOR CHRISTMAS IS RISK RETENTION?

*By Christmas Eve 2016, credit risk-retention requirements will be in effect for all applicable asset classes in the US.[1] Leading US law firm **Mayer Brown** talks through the key considerations that may be relevant to Australian-origin issuers.*

On October 22 2014, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), the Federal Housing Finance Agency (FHFA) and the Department of Housing and Urban Development (DHUD) jointly announced that the six federal agencies had approved a joint final rule implementing the credit-risk requirements of Section 15G of the Securities Exchange Act of 1934, as amended.

While risk-retention rules in the US will take effect at the end of 2016, and already have been in effect for residential mortgage-backed securities (RMBS) since the end of last year, the European market has grappled with its own risk-retention rules since 2009. In fact, many European securitisations have complied with the US requirements. Although some aspects of the European and the US risk-retention rules overlap, a noteworthy distinction is that the European rules place the regulatory burden on compliance with the investor while the US rules place the onus on the securitiser.

Section 15G, which was added pursuant to Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, generally requires the six overseeing agencies to jointly prescribe regulations to require any securitiser[2] of asset-backed securities (ABS) or its majority-owned affiliate to retain at least 5 per cent of the credit risk of the assets supporting its securities.

Section 15G also provides that its regulations prohibit the sponsor from eliminating or reducing its credit exposure by hedging or otherwise transferring its retained credit risk. Section 15G exempts certain types of assets from the risk-retention requirements, and authorises the implementing agencies to exempt or establish a lower risk-retention requirement for other types of assets and to establish separate rules for different asset classes.

FOREIGN-ORIGIN TRANSACTIONS

The agencies also exempted predominantly foreign-related transactions from the risk-retention requirements. The exemption, however, is not meaningful to any of the recent Australian transactions issued into the US because, to receive the benefit of the exemption, certain requirements must be satisfied.

These requirements are that the securitisation transaction is not registered under the Securities Act of 1933, that no more than 10 percent of the ABS interests are sold into the US, that neither the sponsor of the securitisation nor the issuing entity is chartered, incorporated or organised under the laws

1. Risk retention was in effect in the US for RMBS as of December 24 2015.

2. Section 15G defined a "securitiser" as either an issuer of an asset-backed security or a person who organises and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer. Section 15G(a)(3) of the Exchange Act.

of the US, and that no more than 25 per cent of the assets collateralising the ABS sold in the securitisation were acquired by the sponsor from a consolidated affiliate of the sponsor or an issuing entity that is located in the US.

Credit-risk retention was first proposed in April 2011 and reproposed with significant revisions in August 2013. It underwent a comment process among agencies and industry groups in the US over the years since its original proposal. The Australian Securitisation Forum and Mayer Brown advocated on behalf of Australian industry participants for relief from the final rule for Australian home-loan securitisations on the basis that the home loans securitised by Australian market participants were already regulated by robust Australian regulations that protect securitisation investors from significant adverse risks.

These home-loan regulations are similar to the US qualified-mortgage regulations that exempt some US residential-mortgage-loan securitisations from the final rule. After extensive discussions with both the SEC and the FHFA, these agencies were not willing to provide further exemptions to grant Australian home-loan securitisations relief from the application of the final rule.

Since the final rule has been in place for securitisers of RMBS, many in the industry have analysed the basic risk-retention requirements. Generally, the sponsor of a securitisation transaction must retain 5 per cent of the credit risk of the securitised assets – determined as of the closing date of such securitisation transaction – in accordance with one of the standard risk-retention options described in the final rule or one of the specialised risk-retention options available for specific classes of assets.

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The standardised risk-retention options include eligible horizontal residual interest (EHRI), eligible vertical interest (EVI) or a combination of both an EHRI and an EVI. In lieu of retaining an EHRI, the sponsor may cause to be established an eligible horizontal cash reserve account (EHCRA) in an amount equal to the fair value of all or a portion of such EHRI.

Generally, the restrictions on the hedging or transfer of a sponsor's retained risk will expire on the latest of two years after closing, when the principal balance of the pool is 33 per cent or less than the original balance, or when the unpaid principal amount of the related ABS interests is 33 per cent or less than the original amount.

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For RMBS transactions, the final rule imposes restrictions on hedging or transfer of a sponsor's retained risk until the later of five years or when the principal balance of the pool is 25 per cent or less than the original balance but in any event not longer than seven years after closing.

EHRI RETENTION

A sponsor may satisfy its risk-retention requirement by holding an EHRI, the fair value of which is to be determined using a fair-value measurement framework under generally accepted accounting principles used in the US. The final rule adopts the definition of EHRI substantially as reproposed.

An EHRI is defined in the final rule as an ABS interest in the issuing entity and may be an interest in a single class or multiple classes, provided that each interest meets, individually or in the aggregate, all the requirements of the definition of EHRI. The EHRI must have the most subordinated claim to both principal and interest in the securitisation transaction and therefore shortfalls must reduce amounts paid to the EHRI prior to any other ABS. These requirements can be achieved by a variety of means including contractual provisions such as the priority of payments.

USING AN EHCRA

In lieu of holding an EHRI, the sponsor can cause to be established and funded, in cash, an EHCRA at closing in the same dollar amount as would be required if the sponsor held an EHRI. Such account must be held by a trustee for the benefit of the issuing entity.

The final rule also includes several restrictions and limitations on the EHCRA. The agencies stated that the intention of these restrictions is to ensure amounts in the account would be available to absorb losses to the same extent as an EHRI.

Funds on deposit in an EHCRA can only be invested in “cash and cash equivalents”. Although “cash and cash equivalents” is not defined in the final rule, the release states: “The agencies view ‘cash equivalents’ to mean high-quality, highly liquid short-term investments the maturity of which corresponds to the securitisation’s expected maturity or potential need for funds and that are denominated in a currency that corresponds to either the securitised assets or the ABS interests.”

The release gives the following as examples of investments that, depending on the specific funding needs of a particular securitisation, might be considered cash equivalents: “[Insured deposits, certificates of deposit issued by a regulated US financial institution, obligations backed by the full faith and credit of the US, investments in registered money-market funds, and commercial paper.”

Amounts in an EHCRA may be released only to satisfy payments on ABS interests on any payment date on which the issuing entity has insufficient funds from any source to satisfy an amount due on any ABS interest.

ELIGIBLE VERTICAL INTEREST

An EVI can be either a single vertical security or an interest in each class of ABS – regardless of whether the class of interests has a face or par value, was issued in certificated form or was sold to unaffiliated investors – issued as part of the securitisation transaction that constitutes the same proportion of each such class.

A single vertical security is defined in the final rule as: “An ABS interest entitling the sponsor to a specified percentage of the amounts paid on each class of ABS interests in the issuing entity (other than such single vertical security).” If a class of interests has no face value, the sponsor will have to hold an interest in 5 per cent of the cash flows paid on that class.

FINANCING RISK RETENTION

The final rule is clear that retained risk, whether in the form of an EVI or EHRI, can be financed by the sponsor of the securitisation or its majority-owned affiliate that is holding the retained interest.

The final rule, however, is very specific that nonrecourse financing arrangements that effectively transfer the risk of ownership of the retained risk to the funding party violate the final rule’s prohibition on transferring or hedging the retained risk to or with a third party.

As a practical matter, this means that the sponsor or its majority-owned affiliate that is retaining the risk must have more assets at risk in the financing beyond simply the retained risk in order to satisfy the final rule, or that the financing must be supported by a guaranty from a creditworthy entity.

Our experience is that lenders have been willing to offer attractive financing on retained interests, particularly EVI, so long as the structure of the financing does not violate the prohibitions on transferring or hedging the retained risk.

Even repurchase facilities are expressly permitted as eligible financing facilities under the final rule. Leveraging the retained risk, particularly EVI, can reduce some of the economic impact of complying with the final rule.

FINAL THOUGHTS

Although the final rule presents various options to securitisation issuers when it comes to satisfaction of risk-retention requirements, Australian RMBS transactions brought to market this year have satisfied risk retention by holding an EVI. While arguably not as economically appealing as using EHRI, satisfying risk-retention requirements via EVI does have the advantage of sidestepping the requirement to calculate the fair value of the EHRI.

Many in the industry are concerned with this calculation from both a proprietary and confidentiality point of view as well as for risk-based disclosure concerns. Underwriters are also concerned with comforting the data presented in the offering document for disclosure of EHRI and fair-market-value calculations.

These concerns aside, we have recently seen some US mortgage-loan transactions use EHRI to comply, so perhaps Australian securitisations in the coming year will also be structured to comply. With the implementation of risk retention for all eligible classes of ABS set to take effect on Christmas Eve 2016, the industry will have to decide whether satisfaction of risk retention via EHRI is practically feasible. Those in the Australian RMBS market might consider this their Christmas present if an approach is adopted for satisfaction of risk retention through EHRI. ■

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