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Credit Risk Retention Rules, Fair Value and Other Accounting Considerations

April 21, 2016

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Legislative Initiatives and Legal Challenges to the Risk Retention Rules

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April 21, 2016

Quick Risk Retention Primer

- Compliance already required for all new RMBS deals; compliance for all other deals beginning December 24, 2016
- Sponsor of a securitization transaction generally must retain at least 5% of fair value as of the closing date of all “ABS Interests” in the transaction
- Forms of Risk Retention:
 - Eligible vertical interest
 - Can be either:
 - A single vertical security or
 - An interest in each class of ABS Interests issued as part of the securitization transaction
 - Eligible horizontal residual interest (or reserve account) or
 - Any combination of the above
 - Special rules for specific types of deals

Implementation

- RMBS

- Securitizations of Qualified Mortgages and GSE securitizations (while in conservatorship) are exempt
- Non-QM deals must hold retention
 - Only a few RMBS deals have been executed
 - Generally holding vertical retention
 - Horizontal requires valuation calculations and disclosures

- Auto

- Registration statements include horizontal, vertical, and L-shaped interests and retention reserve accounts

- Credit Card

- Revolving Pool Securitizations option
- Seller's interest generally satisfies – must be pari-passu or partially or fully subordinate interest

Implementation (Cont'd)

- CMBS
 - B-piece Buyer additional option
 - Issue is how to capitalize retention
 - Large loan deals have no B-piece and retention would be investment grade
- CLO
 - Collateral Manager required to retain
 - Similar issue is how to capitalize retention

CLO Industry Reactions

- Why us?
 - Not originate-to-distribute
 - CLO manager acts as agent for CLO
 - Collateral acquired in secondary transactions
- Regulators confused and over-reached
 - LSTA sued in November 2014 in DC Court of Appeals claiming that:
 - CLO managers are not “securitizers” and cannot be subjected to risk retention
 - The federal agencies misconstrued the meaning of “credit risk” by requiring a horizontal equity slice equal to 5% of the fair value
 - The federal agencies acted arbitrarily by failing to consider less costly alternatives proposed by commenters
 - Hearing on February 5 (audio: <https://www.cadc.uscourts.gov/recordings/recordings.nsf/>)

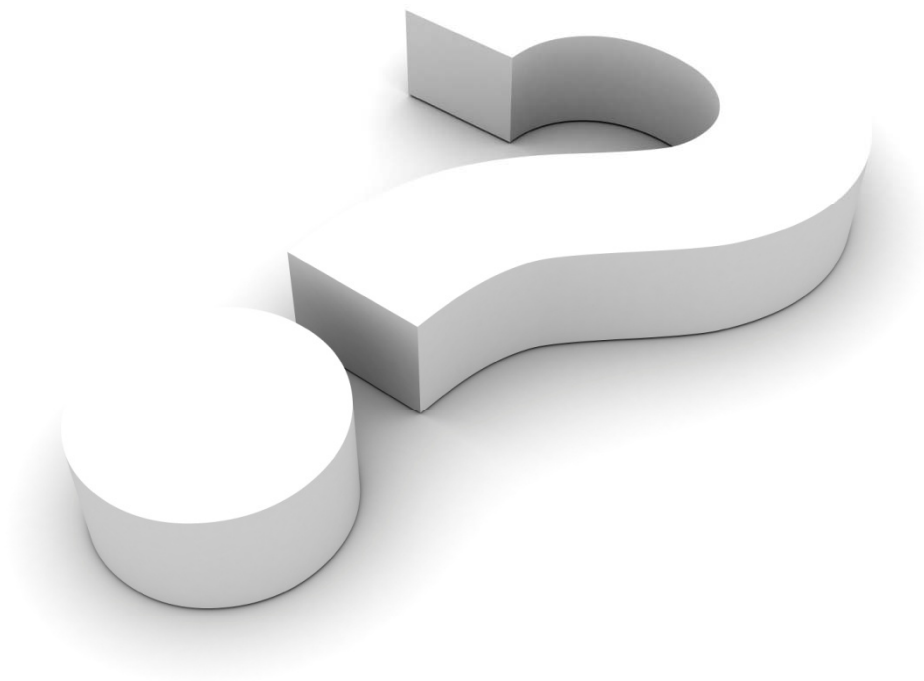
CLO Legislative Efforts

- “Qualified CLO” bill
 - Builds on LSTA comment letter to CRR re-proposal
 - Passed (as [H.R.4166](#)) with bipartisan support out of HFSC in February 2016
 - Requires:
 - Asset quality
 - Asset portfolio diversification
 - Alignment of manager and investor interests
 - Manager must be a registered investment adviser
 - Transparency and reporting for investors

Current legislative proposal (H.R.4620 — 114th Congress 2015-2016)

- Would amend Section 15G to permit the EHRI to be structured with 2 holders in a senior-subordinate format
- Would also exempt single property (or single cross-collateralized group) CMBS from risk retention
- Would require revision to regulations to broaden definition of "qualified commercial real estate loan" (note blended pool is permitted)

QUESTIONS



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Potential Solutions for Compliance by CLOs, CMBS and Other Asset Classes Seeking to Raise Capital and Leverage Retained Interests

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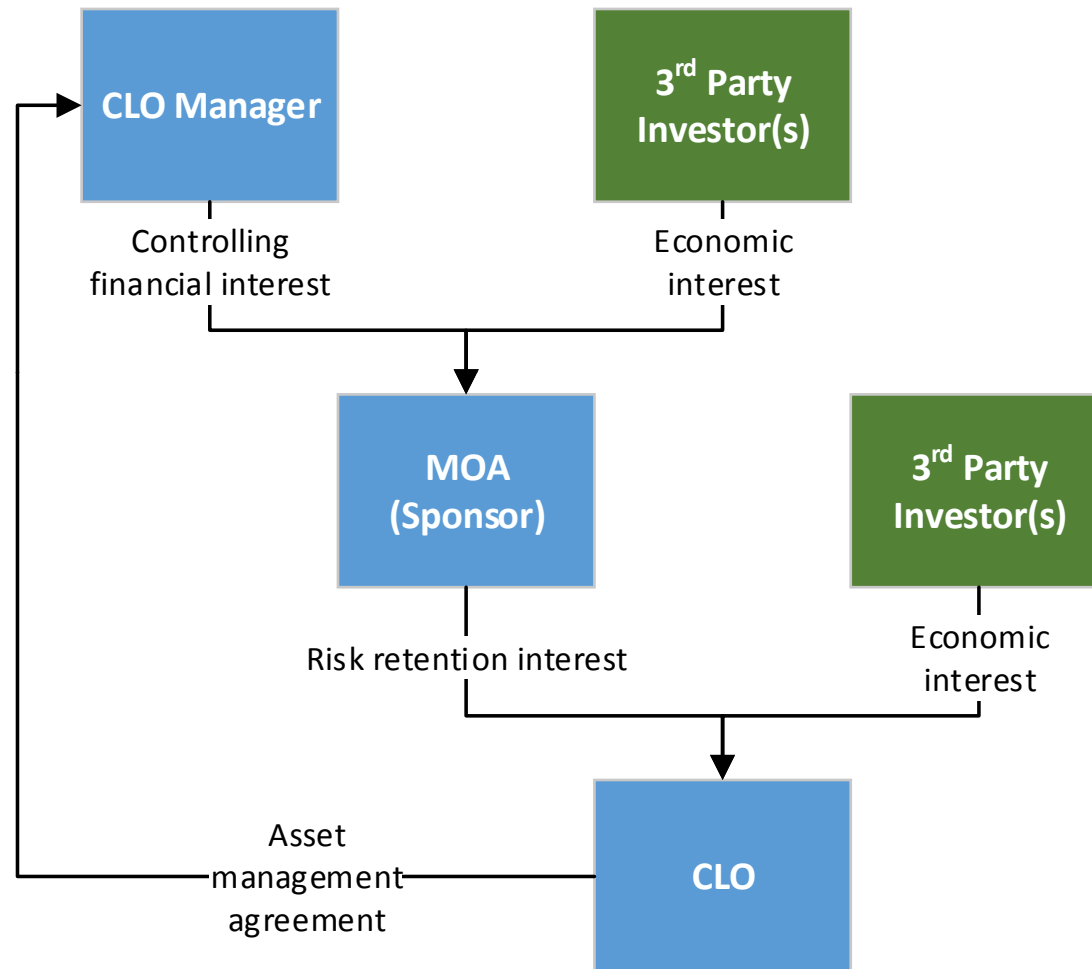
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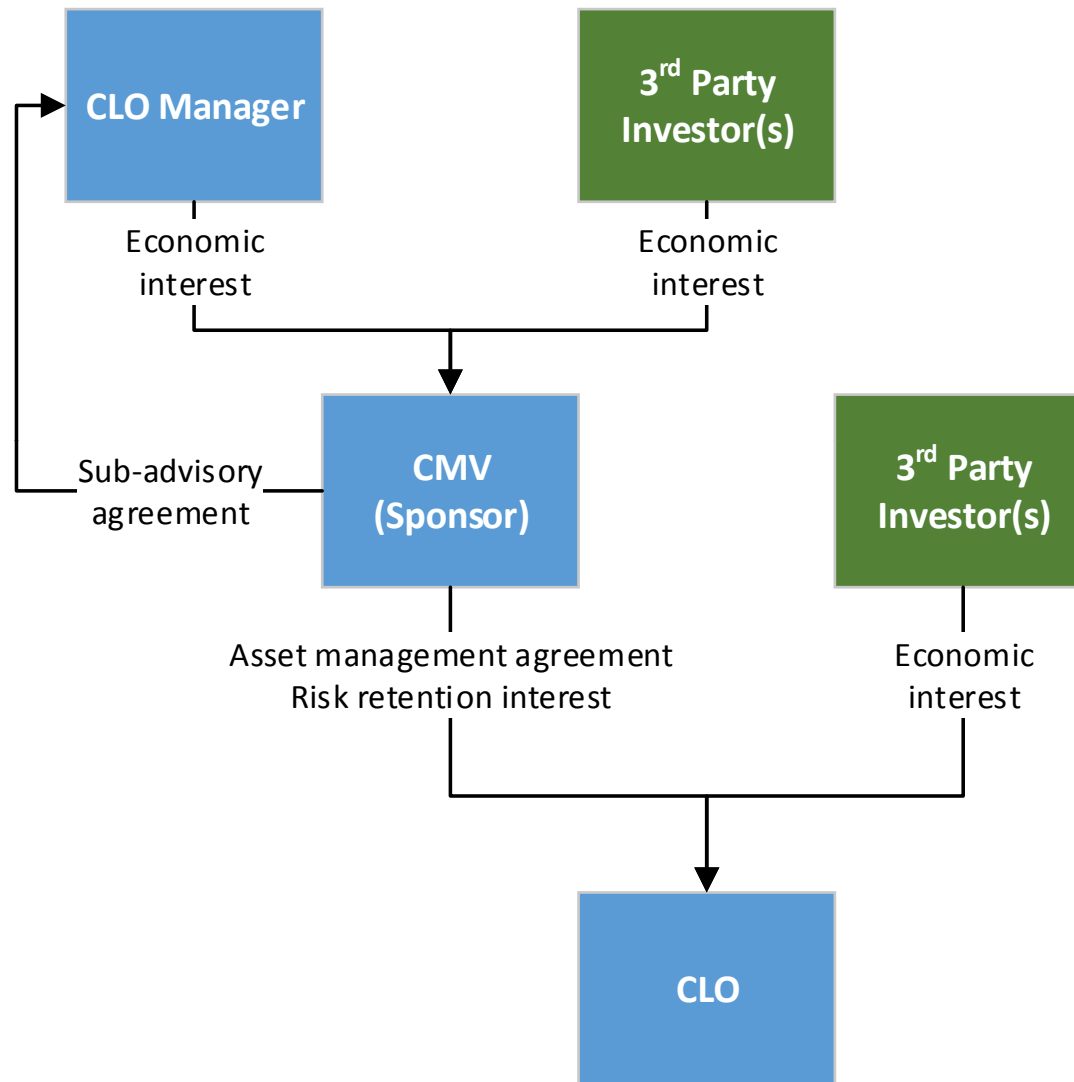
Risk Retention Solutions in the CLO Market

- **Direct capitalization** – CLO Manager obtains capital from a related entity (e.g., its parent) to finance its purchase of risk retention securities and continues to provide management services to CLO.
- **Majority owned affiliate (MOA)** – CLO Manager raises capital from 3rd party investors through CLO Manager-created MOA to finance the purchase of risk retention securities. Key accounting consideration is that MOA needs to be consolidated by the CLO Manager.
- **Capitalized manager vehicle (CMV)** – CLO Manager raises capital from 3rd party investors through CLO Manager-created CMV to finance its purchase of risk retention securities. Instead of CLO Manager being the asset manager, CMV is the primary asset manager. CMV then hires CLO Manager as sub-advisor. Key accounting consideration is making sure CMV is NOT consolidated by CLO Manager.
- **Alternative for CMBS structure** – B-piece buyers (holders of the residual tranche of CMBS) can meet the risk retention requirements rather than the Sponsor/Asset Manager having to hold the securities.

Example – Majority Owned Affiliate (MOA)



Example – Capitalized Manager Vehicle



CMBS B-Piece Option

- A sponsor's risk retention obligation can be satisfied in whole or in part by having B-Piece Buyers hold an EHRI.
- What is required for the B-Piece Option?
 - Number of B-Piece buyers. There can be no more than two B-Piece Buyers, and if there are two, each B-Piece Buyer's interest must be pari passu with the other B-Piece Buyer's interest.
 - Composition of collateral. The CMBS must be collateralized solely by commercial real estate loans and servicing assets.
 - Source of funds. Each B-Piece Buyer must pay for the B-Piece in cash at the closing of the CMBS without financing from a transaction party or its affiliate.
 - Loan Review. Each B-Piece buyer must conduct an independent diligence review of each loan meeting specified minimum standards prior to the sale of the related CMBS.
 - Affiliation and control rights. The B-Piece Buyer may not be affiliated with any transaction party other than an investor, the special servicer or one or more originators (as long as the loans originated by the affiliated originator or originators collectively comprise less than ten percent of the cut-off date principal balance loans included in the CMBS).

CMBS B-Piece Option

- Operating Advisor. The CMBS transaction documents must provide for:
 - The appointment of an operating advisor that is not affiliated with other parties to the CMBS; does not directly or indirectly have any financial interest in the CMBS other than fees for acting as operating advisor; and is required to act in the best interest of, and for the benefit of, investors as a collective whole.
- Hedging, transfer and pledging. Each B-piece buyer and its affiliates generally must comply with the hedging and other restrictions as if it were the retaining sponsor, except that such restrictions will not apply after each loan in the related CMBS transaction has been defeased.

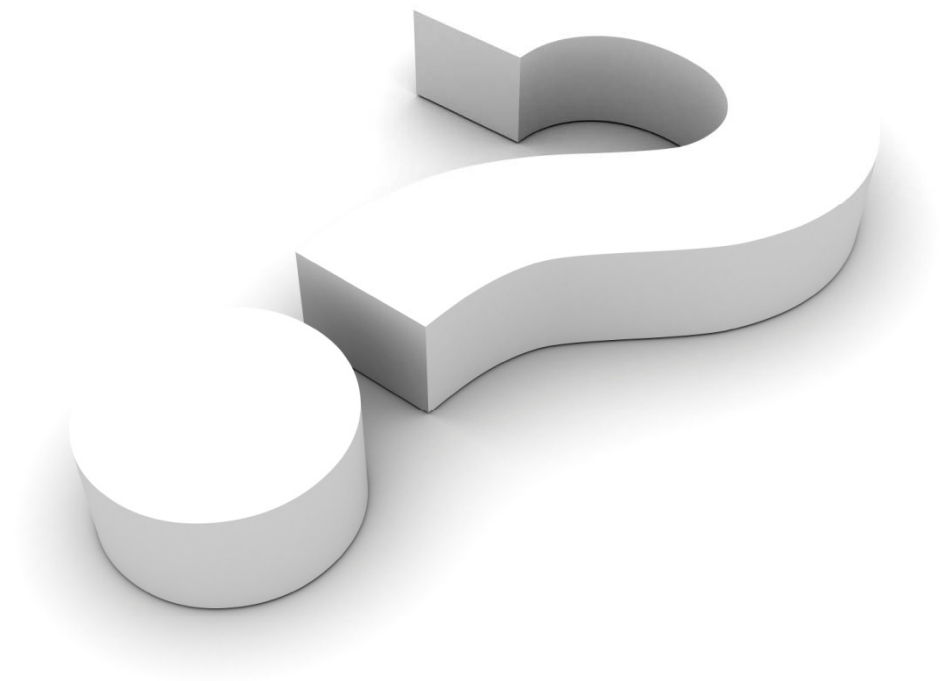
CMBS B-Piece Option

- Advantages of B-Piece Option:
 - All or a portion of risk retention obligation can be satisfied by a party other than the sponsor
 - Some sponsors may not be able or willing to satisfy the risk retention requirement
- Challenges of B-Piece Option:
 - The current market practices of B-Buyers do not satisfy risk retention and would need to change
 - Size of B-Piece
 - Holding Period
 - Financing restrictions
 - B-Buyer bargaining power
 - Disclosure issues
- Alternatives:
 - B-Piece Buyers' or other non-bank sponsors as issuers
 - MOA

Other Asset Classes/Issues

- What constitutes “full” recourse?
- Can and, if so, when does “hedging” result in an impermissible financing?

QUESTIONS



Disclosure and Determination of Fair Value

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Risk Retention: Fair Value Requirements

- Sponsor of a securitization transaction generally must retain at least 5% of fair value as of the closing date of all “ABS Interests” in the transaction
 - Fair value determination is not required for vertical risk retention or the seller’s interest option for revolving pool securitizations
 - Fair value required to be determined using a fair value measurement framework under U.S. GAAP

Risk Retention: Pre-pricing Disclosure of Fair Value

- Sponsor must disclose to potential investors a reasonable period of time prior to sale:
 - The fair value of the EHRI that the sponsor expects to retain at closing (expressed as a percentage of the fair value of all ABS interests issued in the securitization and dollar amount)
 - If the specific prices, sizes or rates of interest of each tranche of ABS are not known, the sponsor may disclose a range of expected fair values based on a range of bona fide estimates or specified prices, sizes or rates of interest
 - If disclosing a range of fair values, sponsor must disclose the method by which it determined any range of prices, tranche sizes or rates of interest

Risk Retention: Pre-pricing Disclosure of Fair Value

- Description of the valuation methodology and all key inputs and assumptions or a “comprehensive description” of such key inputs and assumptions, including (but not limited to):
 - Discount rates and the basis of forward interest rates used
 - Loss given default; default rates and lag time between loss and recovery
 - Prepayment rates
 - If description includes a curve(s), a description of the methodology used to derive the curve(s)
 - Summary description of reference data set or other historical information used to develop key inputs and assumptions

Risk Retention: Post-Closing Disclosure of Fair Value

- A reasonable period of time after closing, sponsor must disclose fair value using actual sale prices and final tranche sizes
 - To the extent the valuation methodology or any key inputs or assumptions that were used to calculate fair value prior to sale differ from the methodology or key inputs and assumptions used to determine fair value at closing, a description of those material differences

Fair Value Measurement Framework

- ASC Topic 820 defines fair value as:

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Fair Value Measurement Framework

- Additional key concepts around “fair value”:
 - Exit price
 - Principal / most advantageous market
 - Market participants
 - Orderly / active market
 - Measurement date
 - Valuation techniques
 - Fair value hierarchy

Fair Value Measurement Framework

- Market Approach

- A valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business.

- Cost Approach

- A valuation technique that reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

- Income Approach

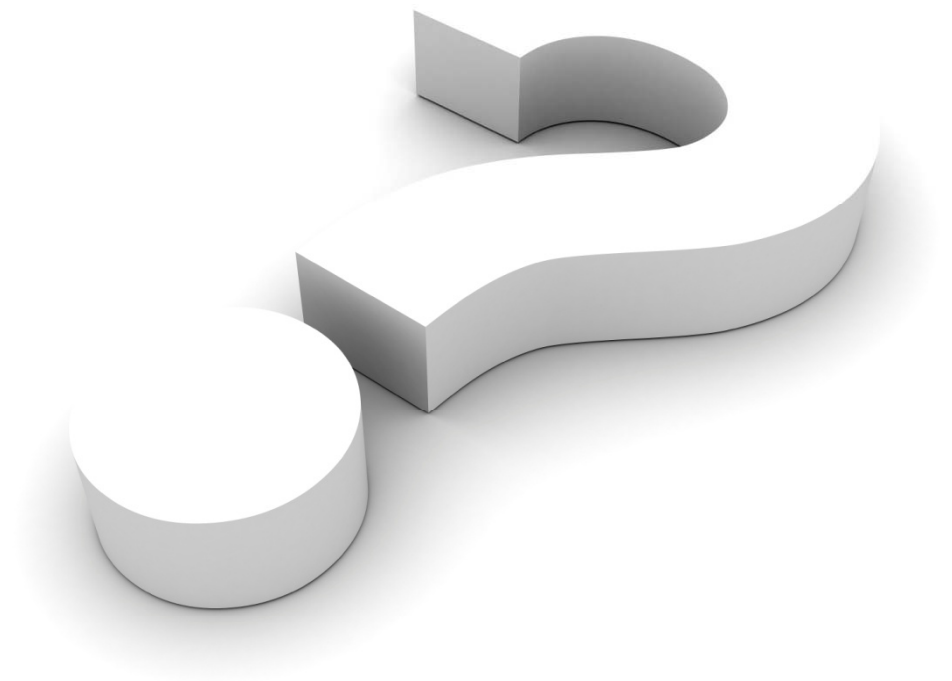
- Valuation techniques that convert future amounts (for example, cash flows or income and expenses) to a single current (that is, discounted) amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts.

Fair Value Measurement Framework

Fair Value Hierarchy

- Level 1
 - Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date.
- Level 2
 - Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3
 - Level 3 inputs are unobservable inputs for the asset or liability.

QUESTIONS



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Accounting and Legal Opinions and Reports Involved in Risk Retention Situations

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Accounting Advice Options

- Why engage accountants for advice on application of consolidation or fair value guidance?
 - There are several sections of the risk retention rules that reference generally accepted accounting principles (GAAP). The two most significant references are:
 - In section __.2 the term majority-owned affiliate (MOA) is defined as
“...an entity (other than the issuing entity) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, such person. For purposes of this definition, majority control means ownership of more than 50 percent of the equity of an entity, **or ownership of any other controlling financial interest in the entity, as determined under GAAP.**”
 - In section __.4(a)(2) the required 5% eligible horizontal residual interest is determined by reference to “a fair value measurement framework under GAAP”.

Accounting Advice Options

- Why engage accountants for advice on application of consolidation or fair value guidance? (cont'd)
 - To make a determination that a structure is compliant with the risk retention rules, a manager may wish to engage accountants to provide advice on GAAP.
 - Lawyers may also be engaged to issue an opinion on whether the securitization structure complies with the risk retention rules. To issue such an opinion, they may need a certain level of comfort from accountants on those aspects of the rules that reference GAAP.

Accounting Advice Options

- What type of accounting advice may be obtained for ownership of a “controlling financial interest” in the MOA?
 - Engaging the auditor:
 - If the manager’s financial statements are audited, the audited financial statements and related notes may already provide sufficient evidence that a controlling financial interest in the MOA is owned by the manager.
 - However, the audited financial statements may not be issued in time.
 - In this case, some audit firms may issue a letter (not a report) from the audit engagement partner analyzing whether a controlling financial interest is owned by the manager.

Accounting Advice Options

- What type of accounting advice may be obtained for ownership of a “controlling financial interest” in the MOA? (cont’d)
 - Engaging a third party accountant:
 - If the manager has no auditor (or the audit is of the managed funds only), engaging a third party accountant is an option.
 - In these cases, a third party accounting firm may be engaged to issue a “report on the application of accounting principles,” which analyzes whether a controlling financial interest is owned by the manager.
 - Also note that some audit firms may not be willing to issue the separate letter by the engagement partner described above; this may also prompt engaging a third party accountant.

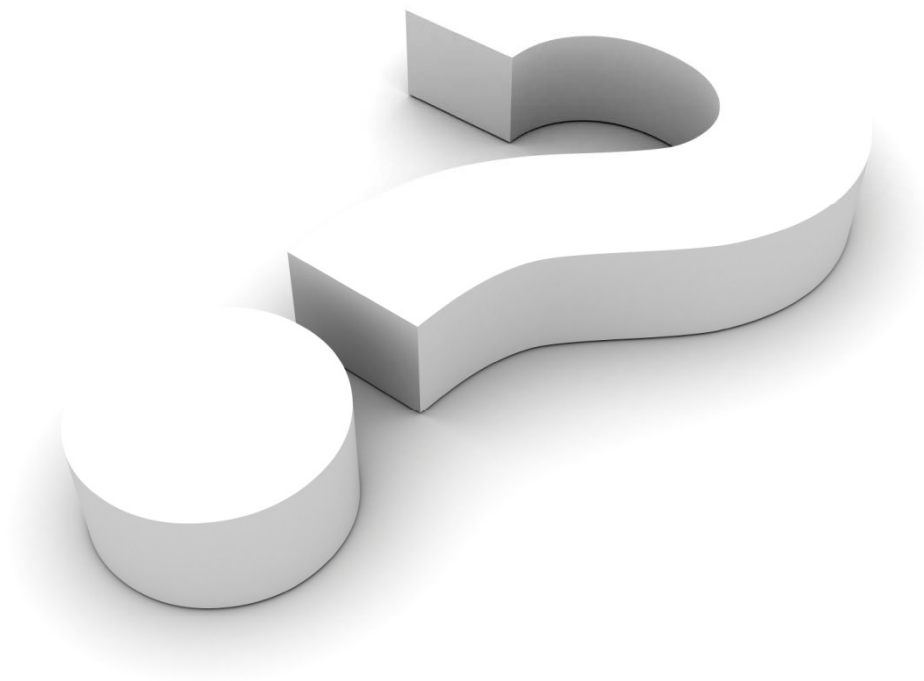
Risk Retention and Legal Assurance

- Third party legal opinions are problematic to deliver
 - Difficult to make a determination as to how the highest court in a jurisdiction would interpret the rules
 - No judicial decisions, very little regulatory guidance and many interpretive issues remain
 - Lack of customary practice; no common understanding of language used in opinions or customary expectations regarding diligence
 - Analysis relies on facts and, in some cases judgments on GAAP (fair value and controlling financial interests)
- Compliance burden is on sponsor; no obligation on counterparties to comply with risk retention rules

Risk Retention and Legal Assurance

- Emerging consensus of ABA Task Force
 - “no violation of law” opinion not appropriate to give, even a reasoned opinion
 - negative assurance re disclosures should be appropriate and feasible
 - Nothing has come to the attention of counsel that caused them to believe the disclosures contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements , in light of the circumstances in which they were made, not misleading
- Does not rule out written advice, memos and perhaps opinions to clients

QUESTIONS





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