Risk Retention Rule — Premium Capture, Commingling, and Servicing*

Robert Barnett

June, 2011

The proposed rule on risk retention jointly published by a number of agencies in April has now become seasoned and has been subjected to considerable analysis. As with many regulations drafted from statutes that were passed in the heat of extreme economic circumstances in the country, they contain some provisions that have what may perhaps be unintended consequences. These are not those issues surrounding the down payment, DTI or LTV requirements, or other high profile issues, although those raise substantial issues also. Rather they are somewhat obscure provisions and important only to those who recognize that if implemented as drafted, they may chill the development of the private secondary RMBS markets. Considering the condition of our housing markets and our economy, that would not be a good thing.

Premium capture cash reserve account. The most glaring problem produced by the proposed rule is also one of the most technical provisions, and one of the most difficult of the rules - namely, the establishment of the premium capture cash reserve account.

The rule requires a securitizer to establish a cash reserve account composed of the premium received by the securitizer at issuance. If part of the premium is retained by the seller, it must account for that in funding the account. The account is in true first loss position, even junior to the first loss position of the risk retained in other mandated first loss positions required by other provisions in the bill, and must remain in place for the entire term of the transaction. Its investment opportunities are limited by the rule to a few conservative investment vehicles.

In other words, 100 percent — not 5 percent — of whatever the premium might be would have to be retained in addition to the 5 percent retention

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

required generally in the rule. That would include the seller's recoupment of fees, the cost of points, overhead, and other kinds of fees, as well as profits. The result would be that lenders would have to charge more up front fees or higher interest rates, a result which might make their offerings non-competitive with offerings of government agencies and the GSEs.

The regulators created this account not under any direct mandate from the statute (such an account is not mentioned in the statute) but based on an argument that absent such a provision, the requirement mandated by the rule to retain risk in the securities could be reduced or possibly eliminated by manipulating the premium that could be taken from the transaction at the front end.

Unfortunately, the operation of the account as drafted in the rule would change the fundamentals of the securitization transaction, and make the normal economics of securitization basically unworkable. The benefits of the efficiencies of securitization would not be available to these issues, and therefore the consumer would most likely have to pay more up front fees (in a period when down payment requirements are increasing under this rule and at the FHA); may not be able to do even that since the total points and fees permitted under Qualified Mortgages and Qualified Residential Mortgages are limited; would not be able to avail themselves of benefits such as rate locks thereby disadvantaging themselves as they try to refinance or move. Lenders would be forced into increasing fees or rates, and the private label market would be unable to compete with the GSEs or FHA for loans within the ambit of those entities.

It is unlikely that the regulators meant to create that result with this provision. Fortunately, there are a few ways that the concern of the regulators can be addressed. For example, if the vertical slice option of retaining risk is chosen, the securitizer cannot manipulate the retention mandated by the general rule. Or, as an alternative to that, the 5 percent risk retention could be measured against the market or fair value of the securities, not the par value. In neither of these cases would a premium capture cash reserve account be needed to protect the concerns of the regulators. Agencies could also decide to limit the account only to profits and on those profits take only 5 percent to harmonize with the general rule.

Hopefully, the regulators will modify the rule before it is published as a final rule, and eliminate the potential major adverse impact the present rule

©2011 Barnett Sivon & Natter, P.C.

would have on the market.

Prohibition against commingling QRM and non-QRM loans in a securitization. Under the risk retention rule, QRM loans lose their exemption from risk retention requirements if they are included in securitizations that contain even one non-QRM loan. That position seems to be dictated by specific language in the statute that creates standards for the securitizations, one of which is that risk retention applies to QRMs if they are commingled with non-QRMs in a securitization.

There is no legislative history on that provision so it is fair to say that it never was openly debated by those that voted on the bill. Its public interest purpose remains unrevealed. One can only assume that the purpose is intended to be consistent with the overall purpose of the risk retention provisions of the Dodd-Frank Act, namely to further the development of a sound private residential mortgage securitization market in which loans are prudently underwritten, and some credit risk is retained for those loans that fail to meet the regulator created standards of Qualified Residential Mortgages.

It would seem that permitting the cost efficiencies of securitization to translate to lower consumer rates and fees would be in the public interest, a result achieved best if the pool of loans from which securitizations draw is large. If QRM and non-QRM loans can be commingled, the pool is immediately larger by definition, and hence benefits to the consumer and to the housing sector generally would more likely flow if commingling is encouraged.

While nothing in the rule prohibits commingling, it discourages it since the QRM loans in the pool lose their exemption from risk retention and hence are priced as though they were non-QRM loans.

That need not be the result. The statute itself says that regulators should take into account the public interest when establishing standards. In addition, it specifically provides authority to the agencies to make exemptions from the standards when doing so is in the public interest and encourages prudent underwriting.

Creating greater liquidity in residential mortgage backed securitizations is in the public interest because it permits the capture of efficiencies that the securitization process provides which then, in turn, are passed on to

©2011 Barnett Sivon & Natter, P.C.

the consumers in the form of lower fees and rates. Nothing in commingling affects the underwriting, since investors will exercise due diligence and will be assisted by the enhanced disclosure provisions that are in the rule. Audit will be straight forward. QRM loans must continue to meet the standards for QRM loans established in the rule - nothing will change that.

In other words, there are no reasons why commingling should not be permitted, and good reasons why it should. The statute permits it.

<u>Servicing standards</u>. The rule requires that the mortgage documents include certain representations by the originator of loss mitigation and other servicing features it provides, and that these be agreed to by any transferee of the loan.

Including the documents as part of the mortgage creates new potential liabilities for the lender, liabilities that generally are not in mortgage documents. Those liabilities will be additionally complicated by the inevitable inconsistent interpretations received as individual parties, state regulators and courts interpret the 50 state laws under which these questions would be judged. Since these conditions would be part of the contract between the parties, regulators would be unable to change them even if as a group they decide to adopt national uniform servicing standards across the broad spectrum of mortgage servicing, a process that is currently underway in a variety of forums and most likely will ultimately happen.

There are a number of oddities associated with this servicing requirement. One is that the rule applies to the least risky, most default remote of any of the total universe of loans — QRM loans. Similarly, because of ambiguities in the language of the rule, due diligence on these mortgages may not be able to predict with certainty that the representations are consistent with the rule, nor that they will remain consistent as over time official interpretations and court opinions flesh out and remove the ambiguities in the language. True sale opinions may be difficult to deliver and, of course, they are essential for securitizations. Rating agencies and investors may also be uncomfortable with the uncertain and untested impact that including servicing agreements in loan documents will have on borrower behavior. Such discomfort might well negate the economic benefits of QRM loans.

The cure for this is also obvious — namely, utilize the current efforts underway to establish uniform nationwide servicing standards and avoid

©2011 Barnett Sivon & Natter, P.C.

using the risk retention rules as a platform for creating a shortened version of servicing standards.

Summary. Modify the premium capture cash reserve account; create improved liquidity for securitization by permitting commingling of QRM and non-QRM mortgages while permitting the QRM loan in those pools to retain their risk retention exemption; and utilize a more appropriate forum for the establishment of uniform national servicing standards.

Robert Barnett is a partner with the law firm of Barnett Sivon & Natter, P.C.

©2011 Barnett Sivon & Natter, P.C.