

March 5, 2015

Finance Alert

Implications of the Final Risk Retention Requirements for ABCP Conduit Sponsors

The final Dodd-Frank risk retention regulations provide challenges for ABCP sponsors. A special rule tailored to ABCP conduits is included in the regulations—and would provide relief for “eligible ABCP conduits” so long as their originator-sellers retain risk in the proper amount and manner on their respective asset pools—but it may not always be feasible to comply with requirements for qualification as an eligible ABCP conduit or to meet the other requirements of that rule. Certain conduits may be required to comply with risk retention requirements in alternative ways.

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, the Federal Housing Finance Agency, the Securities and Exchange Commission and the Department of Housing and Urban Development (the Joint Regulators) issued a release (the Adopting Release) adopting final risk retention regulations (the Regulations) to implement the requirements of Section 15G of the Securities Exchange Act of 1934, as amended (1934 Act), as added by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). The adoption of the Regulations followed a long period of consideration, including an initial proposal on March 29, 2011 (the Initial Proposal) and a reproposal on August 28, 2014 (the Reproposal). The Regulations were published in the Federal Register on December 24, 2014, and compliance is required for residential mortgage securitizations one year after publication, and for other securitizations two years after publication.

This alert focuses on aspects of the Regulations that are relevant to participants in the asset-backed commercial paper (ABCP) market, including some matters specific to ABCP, and some applicable to asset-backed securities (ABS) generally.

Basic Principle of Risk Retention

Except as otherwise specifically provided in the Regulations, the sponsor¹ of a securitization transaction (or a majority-owned affiliate of the sponsor) must retain a 5% economic interest in the credit risk of the securitized assets in one of the forms prescribed in the Regulations. The Regulations define a securitization transaction as a transaction involving the offer and sale of an “asset-backed security,” as defined under the 1934 Act², by an issuing entity.³

The “standard” form of risk retention available for all structures and asset classes is through retention of (1) an eligible vertical interest, (2) an eligible horizontal residual interest or (3) any combination thereof. An eligible vertical interest is a 5% interest in each ABS interest⁴ issued by the issuing entity, although it may be represented by a single security rather than separate portions of each such ABS interest. An eligible horizontal residual interest is a 5% first loss ABS interest issued by the issuing entity. An eligible horizontal cash reserve account may be established instead of some or all of an eligible horizontal residual interest. Specific alternative forms of risk retention are available for revolving master trusts, eligible ABCP conduits (as described below), commercial mortgage-backed securities, Fannie Mae and Freddie Mac asset-backed securities, open-market CLOs and qualified tender option bonds. Risk is not required to be retained, or the amount of risk required to be retained is reduced, with respect to securitizations involving certain types of assets deemed to be of high credit quality, as discussed below.

¹ A “sponsor” is defined in Section 2 of the Regulations to be “a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.” The release specifically notes that an ABCP arranger or manager should be viewed as a sponsor and “securitizer” for purposes of the Regulations and Section 15G notwithstanding that it does not itself transfer assets to the ABCP conduit. If there are multiple sponsors, each is responsible for ensuring that at least one of the sponsors (or majority-owned affiliates) satisfies the risk retention requirement.

² Section 3(a)(79) of the 1934 Act states that “the term ‘asset-backed security’

(A) means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including—

- (i) a collateralized mortgage obligation;
- (ii) a collateralized debt obligation;
- (iii) a collateralized bond obligation;
- (iv) a collateralized debt obligation of asset-backed securities;
- (v) a collateralized debt obligation of collateralized debt obligations; and
- (vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and

(B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.”

³ The issuing entity is defined in Section 2 of the Regulations as “the trust or other entity: (1) That owns or holds the pool of assets to be securitized; and (2) In whose name the asset-backed securities are issued.”

⁴ An ABS interest is defined in Section 2 of the Regulations as “(1) Any type of interest or obligation issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest or residual interest (other than an uncertificated regular interest in a REMIC that is held by another REMIC, where both REMICs are part of the same structure and a single REMIC in that structure issues ABS interests to investors, or a non-economic residual interest issued by a REMIC), payments on which are primarily dependent on cash flows of the collateral owned or held by the issuing entity; and (2) Does not include common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests that: (i) Are issued primarily to evidence ownership of the issuing entity; and (ii) The payments, if any, on which are not primarily dependent on the cash flows of the collateral held by the issuing entity; and (3) Does not include the right to receive payments for services provided by the holder of such right, including servicing, trustee services and custodial services.”

The percentage represented by an eligible horizontal residual interest is measured by its fair value as compared with the fair value of all ABS interests issued by such issuing entity. The fair value is to be determined in accordance with GAAP, on the closing date of the securitization transaction. A sponsor electing to satisfy the requirement by utilizing an eligible horizontal residual interest is also required to disclose, a reasonable period of time prior to sale, the material terms and fair value (as a percentage of the fair value of all ABS interests to be issued) of the retained eligible horizontal residual interest, the valuation methodology used to determine such fair values, and all significant inputs used to measure such fair values. Certain requirements in the Reproposal that would have required reporting of a closing date projected cash flow rate and principal repayment rate, as well as restrictions on the rate of payment on an eligible horizontal residual interest, were not included in the Regulations as finally adopted.

Complete exemptions from the risk retention requirement are provided if all of the assets supporting the asset-backed security consist entirely of qualified residential mortgages (QRMs), qualified commercial loans, qualified commercial real estate loans or qualified automobile loans. Further exemptions are provided to the extent the assets are issued by the United States or an agency thereof, or are 100% guaranteed by the United States or an agency thereof,⁵ or where the securities themselves are so guaranteed. There are further exemptions relating to residential, multifamily or health care facility mortgage loans fully or partially insured or guaranteed by the United States or an agency thereof, certain agricultural loan securitizations, state and municipal securitizations, qualified scholarship funding bonds, certain public utility securitizations, certain resecuritizations and securitizations of seasoned loans.

In a number of cases, the risk retention requirements may be satisfied to the extent originators, rather than securitizers, satisfy the risk retention requirements. Under the general rule, the risk retention interest may be assumed only by originators contributing at least 20% of the assets, and only up to a *pro rata* portion equivalent to the portion of assets contributed. Further, each originator must retain risk on the entire pool, and not just on the assets contributed by it. As described below, the special provisions relating to an eligible ABCP conduit allocate risk retention to all originators regardless of percentage contribution, and in each case solely with respect to assets contributed by them.

The sponsor, or other permitted retainer of risk, may not transfer or hedge the risk retention interest (other than by way of broad market hedges) until expiration of the applicable seasoning period, nor may it finance its position on an effective nonrecourse basis, although it may retain its interest by way of a controlled subsidiary. For residential mortgage-backed securities (RMBS), transfer or hedging is permitted at the earlier of (a) any time after five years when the pool is down to 25% or less of the original balance, or (b) seven years. For other asset classes, transfer or hedging is permitted after the latest of (a) the date when the pool is down to 33% of the original pool balance, (b) the date when the total principal obligations under the

⁵ A special provision is included in the Regulations with respect to student loans made under the Federal Family Education Loan Program (FFELP) that are only partially guaranteed. Risk retention is still required, but may be limited to a portion of the assets depending on the amount that is guaranteed. If the loans are at least 98% guaranteed, the risk retention requirement is reduced to 2%. For securitizations of other FFELP loans, the requirement is reduced to 3%.

transaction's ABS interests are down to 33% of the original principal obligation balance, and (c) two years after the closing.⁶

Risk Retention for ABCP Conduits Under the Regulations

Although ABCP does not appear to clearly fit within the definition of “asset-backed security” under the 1934 Act, it nevertheless is arguably treated as such in other contexts⁷, and the Regulations clearly state that ABCP is to be treated as an asset-backed security for purposes of risk retention. In addition, although commenters noted that the requirement for 100% liquidity coverage represents full retention of credit risk by the liquidity provider, the Joint Regulators continue to view an unfunded provision of full liquidity and credit support as not constituting the retention of risk.

An ABCP conduit must satisfy applicable risk retention requirements upon its first issuance of ABCP after the date on which compliance is required, even if the conduit itself was formed and active prior to such compliance date.

A sponsor of an ABCP conduit can approach risk retention in three different ways:

1. It can structure the program to come within an exemption (the ABCP Exemption) for an “eligible ABCP conduit” (as defined below), including holding only ABS interests issued by “intermediate SPVs”⁸ owned by participating originator-sellers and requiring each such originator-seller to hold a risk retention interest;
2. It can limit the conduit's assets to those, such as QRMs, qualifying commercial loans, qualifying commercial real estate loans, or qualifying automobile loans, that would provide a complete exemption from risk retention requirements; or
3. It (or a majority-owned affiliate) can hold a “standard” risk retention interest in the conduit itself.⁹

The three approaches cannot be combined, except to the extent holding certain assets described in clause 2 may reduce the amount of risk retention required under clause 3. In particular, an

⁶ There is a special provision for commercial mortgage-backed securities (CMBS), permitting transfer after five years to third-party purchasers that satisfy certain asset review and other requirements applicable to permitted initial third-party purchasers, subject to the further requirement that there never be more than two third-party purchasers of such ABS interests.

⁷ See, for example, Rule 3a-7 promulgated under the Investment Company Act of 1940, as amended, which explicitly addresses ABCP and, as described in the adopting release therefor, SEC Release IC-19105, treats ABCP notes as “securities which entitle their holders to receive payments that depend primarily on the cash flow from eligible assets” (a concept similar to that used in the definition of an asset-backed security), notwithstanding that payments are largely made from rolling the commercial paper and from a liquidity facility.

⁸ An “intermediate SPV” is defined in Section 6 of the Regulations as an SPV that (1) is a direct or indirect wholly-owned affiliate of the originator-seller or is an “orphan” subsidiary owned by a trust or corporate service provider, (2) is bankruptcy-remote, (3) acquires assets originated by the originator-seller or a majority-owned affiliate or ABS issued by another intermediate SPV that are collateralized solely by such assets, and (4) issues ABS interests collateralized solely by such assets.

⁹ Although the sponsor of the ABCP conduit would satisfy its obligations under the Regulations with standard risk retention without imposing any requirements on participating originator-sellers, such originator-sellers may themselves be regarded as issuing asset-backed securities and accordingly may have their own risk retention requirements.

ABCP conduit relying on the ABCP Exemption must rely exclusively on compliance with such exemption in full.

Utilizing the ABCP Exemption and Assigning Risk Retention to Participating Originator-Sellers

An ABCP conduit generally can satisfy the requirements of the ABCP Exemption if (1) it qualifies as an eligible ABCP conduit, (2) for each ABS interest the ABCP conduit acquires, the participating originator-seller¹⁰ retains an economic interest in the credit risk of the underlying assets as required under the standard risk retention or revolving pool securitization risk retention provisions of the Regulations and (3) the ABCP conduit sponsor complies with certain procedural and administrative requirements required by the Regulations. This approach can be applied to an ABCP conduit that acquires assets in the form of ABS or in the form of loans secured by and payable from underlying receivables.¹¹

An eligible ABCP conduit is defined in Section 6 of the Regulations as an ABCP conduit that:

- Is bankruptcy remote or otherwise isolated for insolvency purposes from the sponsor of the ABCP conduit and from any intermediate SPV;
- Acquires ABS interests that are
 - Collateralized solely by assets originated by an originator-seller, and by servicing assets;
 - Special units of beneficial interest (or similar ABS interests) in a trust or special purpose vehicle (SPV) that retains legal title to leased property underlying leases originated by an originator-seller that were transferred to an intermediate SPV in connection with a securitization collateralized solely by such leases and by servicing assets;
 - ABS interests in a revolving pool securitization collateralized solely by assets originated by an originator-seller, and by servicing assets; or
 - ABS interests of the foregoing types secured in whole or in part by assets acquired in certain business combinations;

¹⁰ The term “originator-seller” is defined in Section 6 of the Regulations as “an entity that originates assets and sells or transfers those assets, directly or through a majority-owned affiliate, to an intermediate SPV, and includes (except for the purposes of identifying the sponsorship and affiliation of an intermediate SPV pursuant to [this definition]) any affiliate of the originator-seller that, directly or indirectly, controls, is majority controlled by or is under common majority control with, the originator-seller. For purposes of this definition, majority control means ownership of more than 50% of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under GAAP.” The inclusion of majority-owned affiliates in the definition of “originator-seller” in the Regulations as finally adopted permitted deletion of references to “Majority Owned OS Affiliate” that appeared in the Reproposal.

¹¹ Though commenters had encouraged the Joint Regulators to permit direct ownership of assets originated by participating originator-sellers subject to appropriate recourse, the Regulations as adopted require that the assets of the ABCP conduit be in the form of ABS interests.

- Acquires such ABS interests in an initial issuance by or on behalf of the intermediate SPV¹² and not in the secondary market;
- Is collateralized solely by ABS interests acquired from intermediate SPVs as described above and servicing assets; and
- Is 100% supported by a regulated liquidity provider,¹³ without regard to the credit performance of the underlying ABS.¹⁴

If the ABCP conduit is to qualify for the ABCP Exemption, each participating originator-seller must retain the risk with respect to the ABS interest issued by its intermediate SPV and acquired by the ABCP conduit in the form of standard risk retention (vertical, horizontal or a combination) or in the form of a seller interest in an issuing entity as provided with respect to revolving pool securitizations.¹⁵ The originator-seller may well itself be a sponsor of a securitization transaction and be independently required to comply with the Regulations with respect to the ABS interests issued by its intermediate SPV, but the ABCP conduit sponsor relying on the ABCP Exemption is also made responsible for assuring that originator-sellers hold their risk retention interests subject to all restrictions (including the restrictions on transfer and hedging) generally applicable to risk retention interests, as described below. To the extent the ABCP conduit sponsor determines that an originator-seller is not complying with its risk retention obligations, it is required to report such breach to ABCP investors and to regulators (including identifying such originator-seller by name), together with a disclosure concerning the remedial steps being taken, which may include removal of the ABS interest of such originator-seller from the ABCP conduit.

To utilize the ABCP Exemption, the sponsor must (i) approve each originator-seller permitted to sell or transfer assets, directly or indirectly, to an intermediate SPV from which the ABCP conduit acquires ABS interests; (ii) approve each intermediate SPV from which it is permitted to acquire ABS interests; (iii) establish criteria governing the ABS interests, and the securitized

¹² Specifically, the ABS interests must be acquired (a) directly from the intermediate SPV, (b) from an underwriter of the ABS interests issued by the intermediate SPV, or (c) from another person who acquired the ABS interests directly from the intermediate SPV.

¹³ A regulated liquidity provider is defined in Section 6 of the Regulations to be (1) a depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813); (2) a bank holding company (as defined in 12 U.S.C. 1841), or a subsidiary thereof; (3) a savings and loan holding company (as defined in 12 U.S.C. 1467a), provided all or substantially all of the holding company's activities are permissible for a financial holding company under 12 U.S.C. 1843(k), or a subsidiary thereof; or (4) a foreign bank whose home country supervisor (as defined in Section 211.21 of the Federal Reserve Board's Regulation K (12 CFR 211.21) has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision, as amended, and that is subject to such standards, or a subsidiary thereof.

¹⁴ It is noteworthy that, in describing 100% liquidity coverage, the Regulations note that "amounts due pursuant to the required liquidity coverage may not be subject to credit performance of the ABS interests held by the ABCP conduit or reduced by the amount of credit support provided to the ABCP conduit." Accordingly, despite use of the terminology "liquidity coverage," the requirement is essentially one of 100% credit enhancement. It is stated in footnote 131 of the Adopting Release, however, that "liquidity coverage that does not require the regulated liquidity provider to pay in the event of a bankruptcy of the ABCP conduit would meet the requirements of the ABCP option adopted in the final rule."

¹⁵ Although the Regulations provide that each originator-seller must satisfy risk retention requirements through standard risk retention or revolving pool securitization risk retention, without reference to exceptions to risk retention requirements, certain provisions in the Adopting Release (in particular those making reference to seasoned loans underlying the ABS interests) and in the release for the Reproposal indicate that risk retention would not be required with respect to ABS interests to which exemptions from risk retention would be available.

assets underlying the ABS interests the ABCP conduit acquires; (iv) properly administer the ABCP conduit and the ABS interests held by it; and (v) maintain and adhere to policies and procedures for ensuring that the requirements for such form of risk retention have been met. In addition, the ABCP conduit sponsor is required to make periodic disclosures to each purchaser of its ABCP and to applicable regulators, which disclosures are comparable to the disclosures generally required of holders of risk retention interests. Such disclosures must be made before or contemporaneously with the first sale of the ABCP and monthly thereafter, including specified information with respect to: (i) the liquidity provider and liquidity facility; (ii) the ABS interests held by the ABCP conduit and the originator-sellers (including their SIC Codes but without a requirement to disclose their individual names¹⁶); and (iii) a description of the percentage and form of risk retention held by each originator-seller.

An Exemption by Limiting Assets

To the extent an ABCP conduit sponsor is unable or unwilling to rely on the ABCP Exemption, it might consider whether an alternative exemption based on the assets held by the ABCP conduit might be available. Each such exemption requires that the particular assets be held directly, rather than as collateral for asset-backed securities or loans held by the conduit.

The Regulations provide an exemption from the risk retention requirement to the extent the assets are limited to QRMs.¹⁷ Although residential mortgage securitization and the definition of QRM was a focus of comments to the Initial Proposal, the QRM exemption provides no benefit to an ABCP conduit unless it directly holds only residential mortgage loans that are QRMs.

The Regulations provide a separate exemption from the risk retention requirement to the extent the assets consist only of certain other qualifying assets, namely qualifying commercial loans,¹⁸ qualifying commercial real estate loans¹⁹ or qualifying automobile loans,²⁰ and provide a

¹⁶ Note that the Initial Proposal would have required disclosure of the names of the participating originator-sellers, but that requirement was not included in the Regulations.

¹⁷ The term “qualified residential mortgage” is defined by reference to the definition of “qualified mortgage” (QM) under the Truth in Lending Act and the regulations promulgated thereunder by the Consumer Financial Protection Bureau (the CFPB). The term is primarily used in connection with certain safe-harbor relief provided under the CFPB’s Ability to Pay rules.

¹⁸ Commercial loans are defined in Section 14 of the Regulations to include any secured or unsecured loan to a company or individual for business purposes, but exclude commercial real estate loans and loans to purchase or refinance one-to-four family residential properties. In order for a commercial loan to qualify for exemption under Section 16 of the Regulations, the originator must have (1) verified and documented the financial condition of the borrower as of the end of each of the preceding two fiscal years and any subsequent stub period; (2) conducted an analysis of the borrower’s ability to service its overall debt obligations during the next two years; and (3) determined that the borrower had (and will have following the making of the loan) a total liabilities ratio of 50% or less, a leverage ratio of 3.0 or less, and a DSC ratio of 1.5 or greater. Loan payments must be based on “level monthly payments of principal and interest that fully amortize the debt over a term that does not exceed five years,” with payments occurring no less frequently than quarterly. The primary source of repayment must be revenue from the borrower’s business operations. Numerous other underwriting criteria are included in the Regulations.

¹⁹ A commercial real estate loan is defined in Section 14 of the Regulations as a loan secured by a multifamily property (having five or more single-family units) or by nonfarm nonresidential real property, “the primary source (50 percent or more) of repayment for which is expected to be (i) The proceeds of sale, refinancing, or permanent financing of the property; or (ii) Rental income associated with the property,” but specifically excluding land development and construction loans, land loans and unsecured loans to developers. Criteria for qualifying commercial real estate loans are set forth in Section 17 of the Regulations, and include (among other things) requirements that the loan be secured by a first lien on the underlying real property and that certain loan-to-value and debt service coverage tests be satisfied. The Regulations identify a number of covenants required in the loan documentation, as well as additional underwriting criteria.

proportionate reduction in required risk retention (subject to a minimum retention of 2.5%) to the extent the asset pool consists only partially of such qualifying assets. The exemption or reduction for such qualifying assets is conditioned upon (1) the securitization transaction being collateralized solely by loans of the same asset class and servicing assets; (2) there being no reinvestment period; and (3) the sponsor providing potential investors and, on request, the appropriate regulators, with specified disclosures. In addition, qualifying assets must meet the underwriting criteria specified in the Regulations for the applicable asset class. Commercial loans, commercial real estate loans or automobile loans are generally not the sole assets of ABCP conduits (and are generally not held directly but rather as collateral for loans or asset-backed securities held by the ABCP conduit); and active ABCP conduits often contemplate the replacement or addition of such assets over time and may therefore be viewed as in a reinvestment period; but if a conduit were designed to hold only a fixed pool of qualifying loans directly and not merely as collateral, the available exemption may be utilized.

Many ABCP conduits are structured so that their assets consist of ABS interests in the form of loans to SPVs that are in turn collateralized by various receivables. Such loans would not meet the requirements for qualifying commercial loans, which are designed to apply to loans made to commercial enterprises. Accordingly, the exemption for securitization vehicles holding commercial loans would likely be available to an ABCP conduit only to the extent it directly holds only commercial loans made to operating business enterprises.

Risk Retention by the ABCP Conduit Sponsor

To the extent the ABCP conduit sponsor is unwilling or unable to satisfy the requirements of either exemption described above, it would be required to hold ABS interests issued by the ABCP conduit that satisfy the 5% risk retention requirement in any of the ways described below. In such an event, the Regulations would not impose an obligation on the sponsor of the ABCP conduit to require originator-sellers to retain any of the credit risk. To the extent any such

²⁰ An automobile loan is defined in Section 14 of the Regulations as “any loan to an individual to finance the purchase of, and that is secured by a first lien on, a passenger car or other passenger vehicle,” but the definition specifically excludes loans to finance fleet sales, personal cash loans secured by previously purchased automobiles, loans on commercial vehicles not used for personal, family or household purposes, or loans for purchase of a vehicle with a salvage title or intended to be used for scrap or parts. Qualifying automobile loans must meet specified underwriting criteria with respect to the borrower’s credit history and confirming that the borrower’s debt-to-income ratio will be less than 36%. In addition, the borrower must make a down payment (including any applicable trade-in allowance) equal to at least 10% of the vehicle purchase price plus title, tax and registration fees, dealer fees and the cost of warranties, insurance or other products purchased with the vehicle. The loan must be a fixed-rate loan that matures within six years (or earlier if the financed vehicle is more than four years old), is payable by level payments, and is secured by a first lien on the vehicle.

originator-seller is deemed to be the sponsor of an issuance of asset-backed securities, however, it would have an independent obligation to satisfy the risk retention requirements of the Regulations, but an ABCP conduit sponsor would not be required under the Regulations to monitor such compliance if it is not relying on the ABCP Exemption.²¹

As noted above, standard risk retention requirements can be satisfied in any of the following forms:

- Vertical risk retention—retention of a 5% portion of each class of ABS interests issued by the ABCP conduit (now permitted to be in the form of a single security rather than a separate 5% interest of each class);
- Horizontal risk retention—retention of a 5% eligible horizontal residual interest or establishment of an eligible horizontal cash reserve account, measured by fair value (and/or an eligible horizontal cash reserve account in place of all or a portion of such eligible horizontal residual interest); or
- Any combination of the vertical or horizontal forms of risk retention in any proportion.

Vertical risk retention could be accomplished by a sponsor of an ABCP conduit by its purchase of 5% of the ABCP issued by the conduit from time to time. Alternatively, the sponsor could hold a horizontal residual interest by holding a subordinated note with a fair value equal to 5% of the fair value of all ABS interests issued by the conduit. We expect that most ABCP conduits will find that vertical risk retention would be a preferable solution in light of the existence of 100% liquidity and credit support and the difficulty in assessing the fair value of eligible horizontal residual interests relative to all ABS interests issued.

Risk Retention by Originator-Sellers

Standard risk retention as described above, as well as risk retention for a revolving pool securitization, may also be required of originator-sellers, whether pursuant to requirements imposed by the ABCP conduit sponsor so that it may satisfy the requirements for the ABCP Exemption, or because the originator-seller is itself the sponsor of an issuance of asset-backed securities. An originator-seller could utilize vertical risk retention by retaining 5% of all ABS interests sold by its intermediate SPV to the ABCP conduit, but it is likely to find horizontal risk retention more useful for some or all of its risk retention requirement given the typical transaction requirement that it hold a first-loss interest. Note that such a first-loss interest must be in the form of an ABS interest, such as subordinated debt or another interest, the payments of which are dependent on payments on the underlying assets, and the fair value of which can be determined. Accordingly, there is some doubt whether common equity in the intermediate SPV,

²¹ Note that, depending on the circumstances, other regulations (such as European Union risk retention requirements or safety and soundness principles for United States regulated entities) may separately impose requirements with respect to retention of credit risk.

which is currently a fairly common form of first-loss interest, could effectively serve as an eligible horizontal residual interest, even though certain equity interests nominally qualify as ABS interests.

Questions Faced by ABCP Conduit Sponsors

Compliance with the ABCP Exemption may require significant modifications to current ABCP conduit programs. In particular, changes may be required to deal with the following ABCP Exemption requirements:

- ABCP conduits will no longer be able to hold ABS interests acquired in secondary market transactions, including assets acquired from other ABCP conduits (subject to a limited exception for transfers between eligible ABCP conduits having the same regulated liquidity provider).
- The exemption requires that all ABS interests held by the conduit be issued by intermediate SPVs. Some conduits have interests not issued by SPVs (*e.g.*, those involving subscription line loans), or such SPVs do not qualify as intermediate SPVs because they are not wholly owned by the related originator-sellers.
- The exemption requires that the assets held by an intermediate SPV consist entirely, with limited exceptions, of assets originated by the related originator-seller, and not acquired by such originator-seller, or such intermediate SPV, in the secondary market. ABCP conduits may not currently impose such restrictions on participating originator-sellers.
- The exemption requires that originator-sellers retain risk through standard risk retention or revolving-pool risk retention. Such risk retention might not be achieved by investment in the common equity of an intermediate SPV, and accordingly modification of the capital structure of intermediate SPVs may be required.

In addition, it is unclear how the ABCP Exemption would be implemented if any of the ABS interests held by the ABCP conduit are collateralized by residential mortgages. It could be argued, for example, that the presence of any residential mortgages would trigger the earlier compliance date (December 24, 2015) for the full ABCP conduit, and would require compliance in full with the ABCP Exemption (including with respect to ABS interests held by the conduit that are not collateralized by residential mortgages) as of that date.

Limitations on transfer, or hedging against, risk retention interests expire with respect to most asset-backed securities at the end of a seasoning period that, for assets other than residential mortgage loans, includes that the outstanding securities be reduced to 33% or less of those initially issued. While that formulation can be met for a pool of static assets that pay previously issued securities over time, it appears it could not be satisfied by an entity, such as an ABCP conduit, that continually issues new securities. Accordingly, an ABCP conduit sponsor would be required to satisfy risk retention requirements (whether through use of the ABCP Exemption, standard risk retention or limiting its assets) throughout the life of the ABCP conduit.

As a result of the Regulations, an ABCP conduit sponsor will likely face a decision between satisfying requirements of the Regulations through standard risk retention (likely by holding 5% of all ABS interests issued by the ABCP conduit) indefinitely, or significantly restructuring existing ABCP conduit transactions and assets held by the ABCP conduit in order to comply with alternative forms of risk retention under the Regulations.

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