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# Implications of the Final Risk Retention Requirements for ABCP Conduit Sponsors—Part II

**Karsten Giesecke, Eric P. Marcus, Henry G. Morriello, Kurt Skonberg, Gary B. Bernstein, and George M. Williams Jr.\***

*The final Dodd-Frank risk retention regulations provide challenges for asset-backed commercial paper (“ABCP”) sponsors. A special rule tailored to “eligible ABCP conduits” is included in the regulations, 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. In the first part of a two-part article, which appeared in the July/August 2015 issue of The Banking Law Journal, the authors reviewed the basic principle of risk retention, explained the exception for eligible ABCP conduits under the regulations, and discussed utilizing the ABCP exemption, which would permit assignment of risk retention to participating originator-sellers. This second part discusses the availability of an exemption by limiting assets held by the ABCP conduit, and satisfaction of risk retention obligations by the conduit sponsor as the sponsor assesses alternative ways for an ABCP conduit to comply with the new regulations, as well as issues faced by ABCP conduit sponsors in connection with such compliance.*

## 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 QRM<sup>1</sup>s. Although residential mortgage

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<sup>1</sup> The term “qualified residential mortgage” is defined by reference to the definition of

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,<sup>2</sup> qualifying commercial real estate loans<sup>3</sup> or qualifying automobile loans,<sup>4</sup> and provide a proportionate reduction

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“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.

<sup>2</sup> 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 percent 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.

<sup>3</sup> 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.

<sup>4</sup> 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 percent. In addition, the borrower must make a down payment (including any applicable trade-in allowance) equal to at least 10 percent of the vehicle

in required risk retention (subject to a minimum retention of 2.5 percent) 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 five percent 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 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

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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.

sponsor would not be required under the Regulations to monitor such compliance if it is not relying on the ABCP Exemption.<sup>5</sup>

As noted in Part I of this article, standard risk retention requirements can be satisfied in any of the following forms:

- Vertical risk retention—retention of a five percent 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 five percent interest of each class);
- Horizontal risk retention—retention of a five percent 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 five percent 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 five percent of the fair value of all ABS interests issued by the conduit. Most ABCP conduits likely will find that vertical risk retention would be a preferable solution in light of the existence of 100 percent 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 five percent 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

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<sup>5</sup> 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.



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, 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.

## ISSUES 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 percent 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 five percent 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.