

Asset Finance & The Dodd-Frank Act

PART 1: SECURITIZATION



Acknowledgements

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Odessa Technologies, Inc. is the developer of the LeaseWave® suite of products, a fully integrated browser-based lease and loan origination and portfolio management system designed to meet world-class standards of scalability and performance required by the largest equipment leasing and finance, vehicle leasing and fleet management companies. LeaseWave® is comprised of a suite of 120 configurable modules that fully automate leasing company operations while generating the accounting entries for every transaction. The company is headquartered in Philadelphia, Pennsylvania and employs a staff of 250 people exclusively focused on the global leasing industry.

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Foreword from William G Sutton, President and CEO, ELFA



The Equipment Leasing and Finance Association (ELFA) is the trade association representing over 500 financial services companies and manufacturers in the U.S. equipment finance sector, which includes financial services companies and manufacturers engaged in financing capital goods. ELFA members are the driving force behind the growth in the commercial equipment finance market and contribute to capital formation.

Each year American businesses, nonprofits and government agencies invest over \$1.2 trillion in capital goods and software (excluding real estate). Some 51%, or \$628 billion, is financed through loans, leases and other financial instruments. America's equipment finance companies are the source of such financing, providing access to capital. Equipment finance companies also finance the export of U.S. manufactured products abroad.

Advocacy on behalf of the industry is a critical benefit of ELFA membership. With the Dodd-Frank Wall Street Reform and Consumer Protection Act now law and into the regulatory process, ELFA is fighting for sound rules that will continue to allow our industry to provide capital to businesses, governments and the non-profit sector for investment in capital plant and equipment.

ELFA's advocacy efforts on the Dodd-Frank law have focused on three main areas of interest for the equipment leasing and finance sector: risk retention rules on equipment finance securitization and syndications; the impact of Section 1071 loan data collection provisions and conflicts with the Equal Credit Opportunity Act (ECOA); and regulation of non-bank financial institutions. These three main issues were identified and prioritized through the efforts of the association's Financial Regulatory Reform Subcommittee of its Legal Committee. The committee is made up of employees at member companies that are experts in the field of regulatory enforcement, and as the implementation of Dodd-Frank continues, the committee members will continue to assess the impact of proposed rules on the industry and determine how involved ELFA will be in the regulatory process.

On risk retention, ELFA submitted two different comment letters during the comment periods in 2011 that requested regulators to create a workable framework for equipment finance securitizations. Equipment loans and securitized assets have significant variations and expected credit performance characterizations. In reviewing the proposed rules, ELFA raised concerns over the amount of detail provided in asset-level disclosures that raise privacy and competitiveness questions. The rules could undercut issuances in the market through group or asset level disclosure as it tries to create comparisons across a very heterogeneous industry. Altogether, the proposed rules could have adverse impacts on the ability of the equipment finance sector to access the capital markets.

Section 1071 of the Dodd-Frank law requires financial institutions to inquire if a commercial entity is a woman-owned, minority-owned or a small business. This provision seems to be in direct conflict with ECOA rules and would necessitate a separate and parallel system for information collection, maintenance, and dissemination in an attempt to comply with both legal requirements. ELFA worked successfully to get a delay in both the issuance of a regulatory framework and implementation of new rules and continues to advocate for the repeal of this provision in the commercial equipment finance space.

Finally, Dodd-Frank created provisions to require non-bank financial institutions that pose a risk to the stability of the U.S. to submit to regulation by the Federal Reserve Board. The law governs companies predominately engaged in financial activities, but exempts companies earning less than 85% of their revenues from financial services from regulation by the Federal Reserve. The Financial Stability Oversight Council in March 2011 defined a significant non-bank financial company as one with \$50 billion or more in assets. A regulatory standard was also created through ELFA's advocacy and is governed by a series of considerations including the amount of leverage, amount and nature of the assets, amount and types of liabilities, off-balance sheet exposures, and the amount of credit provided to commercial and retail customers.

ELFA member company employees volunteer time and energy toward determining our industry's policy position, drafting comments and testimony, and even meeting with the appropriate regulators to ensure our industry is properly represented. Regulatory advocacy, in this case Dodd-Frank, is just one dimension of the benefits of ELFA membership.

For more information, please visit the Advocacy page on the ELFA website at www.elfaonline.org/Advocacy/Fed/.

William G. Sutton, CAE
President and CEO, ELFA

Securitization And The Dodd-Frank Act: Asset Finance Implications



The Wall Street Reform and Consumer Protection Act, passed by the US Congress in July 2010, has brought a wide range of changes to the regulatory environment for US banking and other financial services.

Known as the Dodd-Frank Act after its legislative sponsors in the two Houses of Congress, Senator Christopher Dodd and Representative Barney Frank, the Act made some immediate changes in the law, while in other areas it mandated Federal agencies to formulate and finalize further changes under their pre-existing statutory powers.

The first in a series of reports on aspects of Dodd-Frank affecting leasing and asset finance, this note deals with the Act's impact on securitization transactions.

The Role Of Securitizations

Though more often associated with portfolios of residential mortgages, credit cards and consumer auto loans, securitization has also become important in the secondary funding market for equipment leases and other business credit receivables.

Essentially the process allows lenders or lessors to free up their balance sheets by selling the major share of a credit portfolio to financial institutions which invest in securities backed by the credit receivables, Unlike an outright sale of portfolios from one lender or lessor to another, the originator of the receivables will continue to administer collections and maintain its interface with the credit customers.

Essential structure

The investors in the financial securities backed by the receivables will potentially have recourse to the obligors (i.e. borrowers or lessees), but not to other assets of the originators. Hence the receivables can be removed from the originator's balance sheet to the extent that risk is transferred to the investors.

Almost always some form of "credit enhancement" is applied to the portfolio to be securitized, so that the securitized instruments can qualify for investment ratings attractive to potential investors. The simplest form of credit enhancement, and the one most widely used in the securitization of leasing portfolios, is "over-collateralization". In this case the value of the portfolio is larger than the amount to be raised from investors through the related asset backed securities (ABS).

There are other credit enhancement alternatives, including the establishment of a separate cash collateral account backing the securities, funded by the "sponsor" party, which is normally the credit originator selling its assets into the bond issuing vehicle.

The issuer of the securities itself is a company (or sometimes a trust) established by the sponsor, described as a special purpose vehicle or entity (SPV/ SPE). The SPV is structured so as to be "insolvency-remote", and in no danger of its assets becoming available to creditors of the sponsor/ originator in case of the latter's bankruptcy.

The SPV itself will have very little equity, with effectively all of its assets being owned by the bond investors. It will be prevented by its charter or articles of association from engaging in extraneous commercial activities, and will often be based in an offshore financial centre.

The following table illustrates a typical kind of bond market securitization of credit receivables, with over-collateralization such that the originator/ sponsor retains 5% of the credit risk. In this example, there are two separate classes of securitization bond.

The senior or Class A bonds, which attract a AAA investment rating, have the lowest level of credit risk. These bondholders will not be affected by any bad debt losses in the portfolio unless these exceed 10% of the present value (PV) of the receivables as at the closing of the securitization issue.

The junior Class B bonds stand in an intermediate position. Their holders are next in line for losses after the originator's losses have exceeded the cap determined by the over-collateralization or risk retention ratio. Consequently they have a lower investment rating, and carry a higher interest coupon, than the Class A bonds.

Illustrative securitization structure (with 5% risk retention by originator) on \$100m credit portfolio

| Party | Nature of interest | PV of interest at inception | Investment rating | Maximum return | Exposure to bad debts losses in portfolio |
|------------------------------|--------------------|-----------------------------|-------------------|---|--|
| Originating lender or lessor | Equity | \$5m | Not applicable | Full recovery of receivables (including expected losses not within \$5m PV), less repayments to bondholders and transaction costs | Full exposure up to \$5m cap |
| Class B bondholders | Junior debt | \$5m | BB | Full repayment of investment with 5.5% interest coupon | Exposure up to \$5m cap, only if losses exceed originator's \$5m exposures |
| Class A bondholders | Senior debt | \$90m | AAA | Full repayment of investment with 3% interest coupon | Only if portfolio losses exceed \$10m combined cap for both subordinated interests |

While the originator initially will continue to collect receivables, the securitization investors will have “kick-out” rights at the point when the originator's maximum loss is exhausted. Where there is more than one class of investor, at each critical point in the accretion of bad debt losses the class of investor next in line for losses will appoint receivers to take over collections.

In the equipment leasing market, a securitized portfolio of operating leases will contain substantial residual value (RV) interests held by the lessor in the value of the equipment at the end of the relevant lease periods. Even in the case of capital leases with no RV, the lessor's ownership rights are of course critical in terms of repossession rights against lessees in default.

Conditionally (if and when the loss exposure of the lessor/ sponsor is exhausted), the ABS bondholders have the right to foreclose on the lessor's ownership interest in the equipment,

Development of ABS bond market

“Private label” ABS bond issues – i.e. those not associated with assets owned or guaranteed by government – first began to develop in the US residential mortgage (RM) funding market in the late 1970s. What is generally regarded as the first ABS securitization, however, was an issue by the Department of Housing and Urban Development (DHUD) in 1970 of bonds backed by mortgages guaranteed by the Federal government institution Ginnie Mae.

The technique spread to the funding of consumer auto loans by 1985, and soon afterwards to credit card receivables. Securitization leant itself most readily to consumer credit receivables because of the “granularity” or standardized nature of the underlying contracts. However, it soon came into use, albeit to a lesser extent and with higher overhead costs in the process of obtaining investment ratings, for portfolios of individually negotiated credit contracts with business customers.

There have now been a great many equipment lease securitization bond issues, alongside larger aggregates in commercial mortgage backed securities (CMBS), and in collateralized loan obligations (CLOs) covering a variety of types of commercial obligors and of loan contracts.

ABS bond issues have been most attractive to long term investment institutions such as pension funds, insurance companies and all types of investment funds.

Banks can also acquire such bonds, though this has tended to be much more prevalent in international markets to which securitization spread from the late 1980s, than in the US funding markets. Other banks, typically smaller banks including some of those active in equipment leasing in the US and many other countries, have accessed the ABS market as originators.

The following table shows the approximate shares of the US ABS market accounted for by the various broad classes of underlying assets, over an eight-year period up to 2009.

| Market shares within US ABS issues, 2002 to 2009 (% of total) | |
|---|----|
| Equipment leases | 1 |
| Floorplan loans | 1 |
| Auto loans | 7 |
| Residential mortgage backed securities (RMBS) | 39 |
| CMBS | 15 |
| Credit cards | 6 |
| CLOs | 7 |
| Student loans | 4 |
| Other receivables | 20 |

Source: SEC and other agencies, “Proposed rule on risk retention” consultation document, March 2011

The volume of securitization issues slumped in the aftermath of the banking crisis of 2008. The next table compares total ABS issues in the various sectors from the peak reached in 2006 to the trough three years later.

| ABS issues before and after the crunch (\$bn) | | |
|---|---------------|--------------|
| | 2006 | 2009 |
| Equipment leases | 8.4 | 7.2 |
| Floorplan loans | 12.2 | 5.0 |
| Auto loans | 82.0 | 53.9 |
| RMBS | 723.3 | 48.1 |
| CMBS | 305.7 | 38.75 |
| Credit cards | 72.5 | 46.6 |
| CLOs | 171.9 | 2.0 |
| Student loans | 65.7 | 20.8 |
| Others | 516.2 | 10.7 |
| Total | 1957.9 | 233.1 |

Source: SEC and other agencies, "Proposed rule on risk retention" consultation document, March 2011

As the table shows, total ABS issuance showed a fall of no less than 88% between 2006 and 2009, reflecting a general collapse of business in sectors like mortgages (both residential and commercial) which were at the heart of the banking and credit crisis. Yet equipment lease securitizations were down by only 14%, and those of auto loans by 34%.

The relatively robust performance of new issuance in the equipment leasing sector reflects the absence of adverse experiences by investors in this type of security over the years. As the Federal Reserve Board has commented: "Equipment loan and lease ABS in general, and AAA-rated securities [within that category] in particular, have displayed strong performance throughout the financial crisis".

"As with auto ABS, the short maturity of the underlying [receivables] means that the level of credit enhancement increases over the life of the security. ... [A] handful of ABS [bond] classes have experienced downgrades [in ratings post-issuance], but most securities have had stable performance or even upgrades over time." (Report to Congress on Risk Retention, October 2010).

The Equipment Leasing and Finance Association (ELFA) has commented: "During the past 20 years, equipment lessors/ lenders have been significant users of securitization facilities. [This] has been a valuable alternative at competitive prices to the bank loan market ... [This] helps to reduce the total prices paid by ... customers of equipment lessors/ lenders, for new productive assets and software".

"Additionally, equipment ABS has allowed both banks and institutional investors to diversify their portfolios. No data have indicated any correlation between practices in the equipment finance sector and causes of the US financial crisis." (ELFA's comment letter on proposed risk retention rule, June 8, 2011).

ABCP bank conduits

Not all securitization issues are in the form of ABS bonds. Some involve much shorter term funding through asset backed commercial paper (ABCP).

ABCP funding is usually for maturities of up to six months. Their maximum maturity, in order to avoid having to be registered like long term bonds under the Securities Act 1933, is 270 days. They are thus attractive to such investors as money market funds.

ABCP was originally used to fund very short-term receivables such as trade credit. However, it was soon adapted to provide rolling funding for receivables with much longer maturities including auto loans.

There is an SPV structure as with ABS securitizations, but the senior interest is issued to a “conduit” for ABCP issues, rather than a class of bondholders. There is no scheduled amortization as with ABS issues, and additional successive issues of CP can be used to maintain the conduit's interest in the underlying assets.

Conduits are sponsored by major commercial banks. They are divided into:

- single seller structures, where the sponsoring bank is the originator of the underlying receivables as part of its lending or other credit business; and
- multi-seller structures, where each SPV comprises credit receivables of a variety of finance companies who are clients of the sponsoring bank.

A pair of new accounting standards taking effect from November 15 2009 (FAS 166 “Accounting for transfers of financial assets” and FAS 167 “Amendment to FASB interpretation no. 46 (a)”) have significant financial reporting implications for banks sponsoring ABCP conduits. On most interpretations of these, conduits will not remove the relevant assets from the sponsors' balance sheets. In this respect US generally accepted accounting principles (GAAP) have come into line with international financial reporting standards (IFRS).

Conduits can nevertheless continue to free up balance sheets for the originators in multi-seller structures, as with ABS issues.

Proposed Risk Retention Rule

Following the financial crisis of 2008, it was widely felt that ABS securitizations, particularly of US sub-prime residential mortgage (RM) portfolios, had been sources of toxic infection in the markets, due to mis-pricing of the credit risks in the underlying receivables. This was perceived not only in relation to the US funding market, but also the London market and other global financial centers where US-originated RMBS were traded, and re-processed into structured investment vehicles (SIVs).

This was attributed in part to over-generous ratings given to the securities, but in part to features inherent in the structure. It was felt in particular that some originators, such as mortgage brokers in the sub-prime market, had retained too little “skin in the game” in RMBS structures.

Section 941 (b) of the Dodd-Frank Act adds a new Section 15G to the Securities Exchange Act 1934. With some exceptions (see below), which the relevant executive agencies were mandated in the Act to refine and prescribe later in final form, there is to be a mandatory minimum risk retention (MRR) of at least 5% in securitization issues.

On March 30, 2011 a consultative notice of the detailed proposed rules (PR) was issued jointly by the relevant agencies. These are:

- the Securities and Exchange Commission (SEC) as regulator for the financial markets;
- the three agencies jointly involved in banking supervision (Federal Reserve Board, Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC));
- the two Federal agencies with responsibilities for the RM market (DHUD and Federal Housing Finance Agency (FHFA)).

Comments on the PR were required by June 10 2011, with the deadline later extended to August 1.

As noted above, a 5% risk-retention level is not untypical for securitization deals arranged in the past. There have nevertheless been many with lower levels of over-collateralization, which will generally be ruled out in the future.

The new general 5% minimum compares with a 10% maximum credit enhancement in order for an arrangement to take the bulk of the receivables off the originator's balance sheet under financial reporting rules.

The risk retention obligation in the Act is placed upon “the securitizer”. It seems clear in the Act that either the issuer (i.e. the SPV) or the sponsor – the party which, if any, would normally retain risk – is within the statutory definition of securitizer, and that either of these parties could satisfy the MRR requirement.

The PR assumes that risk retention will normally lie with the sponsor. In most cases this will be the originator of the credit receivables, who will normally be best placed to retain an equity interest and continue to administer collections.

There will, however, be cases where the sponsor was not the originator. This will apply for example in the case where portfolios may have been sold on by the originator outside the securitization market, and where the buyer subsequently sponsors a securitization to include the relevant receivables.

The PR would allow the originator to assume the MRR requirement in place of the sponsor by mutual agreement where these parties are not identical. That would not be appropriate in the type of case referred to above, but would seem relevant to the case of multi-seller conduits.

Permitted forms of risk retention

The PR would allow a number of alternative mechanisms for a sponsor to retain the required level of risk. In addition to the usual methods of credit enhancement in equipment lease securitizations – i.e. over-collateralization of assets or cash collateral accounts (see p.5 above) – which the PR describes as “horizontal” risk retention, it would also allow:

- “vertical” risk retention, through the sponsor taking at least 5% of all the bond classes to be issued;
- “L shaped” risk retention, involving at least half of the MMR to be taken in each of the horizontal and vertical forms;
- retention of ownership of a representative sample of the assets destined for the securitization by the originator.

It seems unlikely, however, that approaches other than the well-established horizontal option will be widely adopted in leasing securitizations.

Proposed “horizontal” rules

In the case of horizontal risk-retention provisions, there are some problematic features of tentative “waterfall” proposals in the PR designed to ensure that risk retention is maintained through the amortization period of the securities. These have been strongly criticized by a specially convened group of respondents to the PR, described as the “Vehicle ABS Sponsors”. They comprise automotive sector finance companies including all the main captive auto financiers in the US market (Ford, General Motors, Chrysler, BMW, Mercedes- Benz, Nissan, Toyota and Volkswagen).

The problem for leases

The agencies' draft Clause (1) of the “eligible horizontal interest” definition require losses of principal on the assets pool to be specifically allocated each period to the most subordinate interest – i.e. that of the sponsor – to reduce its par value.

The Vehicle ABS Sponsors point out: “While this feature is commonplace in RMBS transactions and in many floor-plan ABS transactions, retail loan and lease [securitizations] do not have loss allocation mechanisms ... Instead [they] treat all collections each period as a single pool of distributable cash ...”

“Where a subordinated residual interest in a retail loan or lease securitization is not explicitly allocated losses, by virtue of its placement at the last position in the waterfall, it is implicitly the first ABS interest to have its distributions reduced or eliminated in a particular period ... [by] losses on the assets pool or other cash-flow disruptions.”

“Clause (1) ... should therefore be modified so that it applies only to securitizations that have a loss allocation feature.”

Commenting further on this and other technical changes which they suggest are necessary in the horizontal risk-retention rules, these finance companies add: “If [our] proposed revisions are not made, virtually all vehicle ABS programs would need to be significantly restructured in order to take advantage of horizontal risk retention ...”

“This would hinder the issuance of vehicle ABS and negatively impact the availability of credit to consumers and businesses. Certain vehicle ABS sponsors would have to consider additionally retaining a 'vertical slice' to satisfy the statutory risk-retention requirements, despite the fact that this is a very expensive method of risk retention.”

ELFA has referred to similar concerns, and commented: “Because equipment ABS is expected to utilize horizontal risk retention exclusively, it is critical that the final regulations include variations which [sponsors] and investors in this market segment have found acceptable during both good and challenging times....”

“[In economic terms] the subordinated cash flow resulting from over-collateralization ... is indistinguishable from the subordinated cash flow running to the most subordinated class of securities (or to the sponsor, as sole owner of the equity cash flow payable to the issuer).”

“Because [the former] remains as securitizer risk retention for the entire time that the ABS are outstanding, it is unnecessary for the final regulations to require that over-collateralization be documented as a Z bond – and it would be uneconomic (as recent discussions by our member companies have demonstrated) to mandate that Class A interest and principal be paid in full before any Class B [returns] be paid.”

Foreclosures and upgrades

The PR suggests that under horizontal risk retention, the sponsor should be prevented from receiving prepayments and recoveries from disposals of equipment in the case where lessees or borrowers default. Commenting on this, ELFA said: “This approach would in effect raise the [retained] risk percentage above the mandated 5%, as the aggregated discounted contract balance of the pool declines (following prepayments and default recoveries) and the sponsor’s ownership interest in the issuer remains static.”

Reinforcing the point made by the Vehicle ABS Sponsors, ELFA commented: “There is a fundamental legal reason [why] ABS equipment rentals are not divided between principal and interest elements ... in contract with MBS and CDO transactions, where there are separate waterfalls...”

“Equipment ABS properly treats all collections – whether scheduled payments, prepayments or default recoveries – as fungible amounts but styled simply as rentals...”

“Additionally, equipment-finance contracts experience an artificially high level of prepayments – not because obligors have sought to exit these arrangements, but because upgrades and additions to financed equipment typically are accomplished by terminating the existing contract [with a prepayment] and entering into a new one for the reconfigured equipment.”

Support from other sectors

The global investment bank Barclays Capital has commented critically on the “waterfall” proposals in the PR in respect of horizontal risk retention, as these affect banking sponsors of securitization transactions. It said: “If a securitizer retains risk through a horizontal slice of the capital stack, capital will be trapped until cash flows finally pay off the bond.”

“The capital charges [under the prudential regulation regime for banks] incurred on that retention over the life of the bond will be held captive ... The capital implications inherent in horizontal risk retention create a disincentive for securitizers to use this option.”

“The representative sample, therefore, looks like a more attractive alternative [risk retention method], but it is [viable] only for large commercial lenders ... This could result in [most ABS categories], including loans to less creditworthy customers, sitting on the books of a few large commercial banks, exacerbating the ‘too big to fail’ risk and potentially crowding out other types of players ...”

The American Securitization Forum (ASF), representing a wide range of ABS market participants, added its voice to those concerned about the rules proposed for risk-retention methods in its comment letter. It said: “If the risk-retention rules are not appropriately designed to accommodate existing market practices, we risk an immediate and significant reduction in the availability of auto loans, student loans, credit cards and business credit throughout our country without gaining material improvements to the risk-retention practices that protected investors even during the worst of the financial crisis.”

“The risk of shutting down the securitization markets is not warranted where investors have been protected by existing risk retention methods. Therefore, it is imperative that the ... regulations accommodate existing market practices that effectively align the interests of sponsors with those of investors.”

Another broad financial sector body, the Securities Industry and Financial Markets Association (SIFMA), has been highly critical of various aspects of the proposed risk-retention rules, including the “waterfall” issues with horizontal risk retention highlighted above by the leasing bodies. SIFMA commented: “[The PR] would change market practices, and impose specific economic costs on securitizers, which will likely be passed on to consumers of credit. We are concerned that the impact on certain asset classes would be extreme, and detrimental to borrowers and the broader economy...”

“The need for fundamental reconsideration of the approach taken by the Agencies to fulfilling the statutory mandate ... could hardly be more urgent... We believe that Congress intended that what the Dodd-Frank

Act provides for - that is retention of at least 5% of the credit risk related to securitized assets – not an artificial mechanism to limit profitability and discourage securitization...”

Cash collateral

In the case of cash collateral accounts, ELFA is concerned that the final regulations could be drawn too narrowly in terms of the form in which the collateral must be held. It argues: “The overriding policy consideration [on collateral accounts] is that 'cash is king'. And the agencies should issue final regulations which [permit] investment ... of cash reserve accounts ... in other than [Treasury bills] and FDIC-insured deposits.”

“There are several other options that are prudent, yield more ... and have been accepted for more than a decade by investors who fiercely demand that cash be invested in fundamentally safe liquid investments.” ELFA urges allowing such options as:

- obligations guaranteed by the Federal government;
- senior debt obligations of GSEs like Fannie Mae and Freddie Mac;
- any obligations of US supervised banks with maturities of up to 360 days; and
- a variety of other investments with the highest short term credit ratings, such as CP or money market funds.

Exceptions

The Act provided for some exceptions to the 5% MRR rule, and mandated the executive agencies to prescribe detailed conditions for the exceptions.

It allowed for zero risk retention in the case of qualifying residential mortgages (QRMs), subject to high credit underwriting standards to be jointly prescribed by all the above executive agencies. It also allowed for MRR rates of below 5% for securitizations of qualifying commercial mortgages, commercial loans and auto loans, subject to minimum credit underwriting standards to be prescribed by the three banking supervision agencies.

In the PR the agencies are in fact proposing a zero minimum for qualifying assets in the above categories, as well as for QRMs.

In the RM sector, the agencies propose tight underwriting criteria to meet the QRM definition, including a maximum loan-to-value (LTV) ratio of 80%, with no more than half the deposit to be funded by unsecured loans from other sources. However, they also propose to exempt from MRR all securitizations guaranteed by either of the government supported enterprises (GSEs) Fannie Mae and Freddie Mac, so long as the guarantor remains in government conservatorship (as both of them have been since 2008).

For qualifying real estate loans to escape the MRR rule, the agencies propose a 65% maximum LTV, together with other conditions including minimum debt service coverage ratios (DSCR) and a prohibition on deferral of either interest or principal repayments.

For qualifying commercial loans (QCLs) the agencies propose conditions including:

- detailed protocols for verifying each borrower's financial conditions over the previous two years, and its ability to service its debt obligations over the next few years;
- specified financial ratios, including minimum DSCR of 1.5, maximum total liabilities ratio of 50% and maximum leverage ratio of 3%;
- security to be taken for loans; and
- loan periods not to exceed five years.

Qualifying auto loans

Another exception is proposed for qualifying auto loans (QALs). These again would attract a zero risk-retention requirement, but the associated conditions are highly restrictive. As currently proposed, QALs must be to private consumers, secured on new or used cars for private use.

Conditions would include:

- maximum ratios of debt to verified income of 36%;
- a three-year backward credit reference check, with specified maximum payment arrears records;
- a minimum 20% down payment (in cash or trade-in), plus payment of tax, title and registration fees;
- used vehicles not to be more than five years old when financed;
- loan terms not to exceed five years; and
- repayments to be based on fixed interest, straight line with no deferrals permitted.

ELFA is critical of the fact that the proposed definitions of both QCLs and QALs exclude leases. It proposes that the QAL category be expanded to include consumer auto leases, and suggests that including leases to commercial users of autos should also be considered.

ELFA is also critical of the proposal to exclude loan financing of tax, title and registration fees within QALs, and of a separate proposal by the agencies to require sponsors to repurchase the entire pool of assets in a QAL where the extent of warranty repurchases exceeds a certain threshold.

On the latter, ELFA comments: “[This] would have the perverse effect of motivating the sponsor to resist making warranty repurchases wherever they would exceed the aggregate limit ...”

“Investors would be dismayed at having the entire transaction prematurely repaid solely by reason of a regulatory initiative which has never, to our knowledge, been imposed by investors in any auto loan or auto lease ABS.”

The Vehicle ABS Sponsors suggests that the QAL standards are too restrictive to be usable. It says: “We do not originate loans using the [QAL] criteria ..., and doing so would have a significant and adverse impact not only on our business models that proved to be resilient through the financial crisis but also on the core mission of those of us that are [captives] – to assist our parent manufacturers in selling cars.”

“...We cannot customize our origination standards to allow us to create pools of the proposed QALs because ... this would likely restrict consumers' access to credit and drive away all but the most creditworthy customers ...”

“Unless the QAL provisions are reworked significantly, we expect that [they] will remain wholly unused, despite the clear Congressional intent to foster such an asset class.”

As an alternative, these finance companies suggest a 2.5% MRR ratio where the related asset pools meet certain characteristics on a pool-wide basis.

Public sector leases

The agencies propose an exemption from MRR for securitization bonds which are issued or guaranteed by state or municipal entities and qualify as exempt securities under Section 3 (a) 2 Securities Act 1933.

ELFA has proposed a wider MRR exemption for securitizations of “municipal obligations”, such as would cover lease portfolios with state and local government lessees for such assets as emergency vehicles, school buses and office equipment.

Proposals for conduits

The agencies have proposed including ABCP conduits in the risk retention rules. The Vehicle ABS Sponsors have added their voice to financial market based respondents in opposing this proposal.

In the case of multi-seller conduits the PR would require sponsors to identify all the relevant originators to the investors.

In a commentary on the PR, the law firm Mayer Brown observed that this would bring “a dramatic change in current practice for virtually all the multi-seller conduits, which have typically not disclosed the names of [originators] to the investors.”

The Vehicle ABS Sponsors are likewise critical of this disclosure requirement. They said: “We value the confidentiality provided by ABCP conduit transactions ... We are aware of no significant indications from ABCP investors that they believe disclosure to be important.”

“We understand that investors rely primarily on liquidity support from the ABCP sponsor ... to backstop the repayments of ABCP.”

International aspects

“Foreign related transactions” are proposed to be exempt under a “safe harbor” provision, if all of the following conditions are satisfied;

- neither the sponsor nor the issuer is incorporated in the US;
- no more than 10% of the securities are sold to US investors; and
- no more than 25% of the assets in the pool are acquired from a US or affiliate or branch of the sponsor or issuer.

Some overseas jurisdictions have been moving towards similar risk retention rules for securitizations arranged in their territories. In particular the European Union (EU), through the terms of Article 122a of the Capital Requirements Directive (CRD) II adopted in 2009 and effective from January 2011, introduced a 5% MRR for any securitizations in which EU regulated credit institutions (i.e. generally banks) invest.

The EU's focus on bank investors as the subjects for its MRR rule, rather than legislating for financial markets as a whole, reflects the greater role of banks as ABS investors in Europe, compared with the US.

There are also other differences in Article 122a compared with the US rules as proposed. The former exempts issues guaranteed by governments, but with no exemptions for specified categories of private label transactions subject to high underwriting standards as proposed in the US.

Mayer Brown comments: “In general, a transaction subject to the PR would also be subject to Article 122a if any of the investors or counterparties are EU credit institutions.”

In a comment letter, Deutsche Bank New York branch said: “Where [we are] involved in securitizations in the US, [we are] likely to be subject both to Article 122a [and] the PR.”

“While there are similarities between the two regimes, [they] differ markedly in a number of respects which, in certain circumstances, may make it impracticable for market participants to comply with both.”

“...We would urge the agencies to consider the express recognition of Article 122a in the final version of the [US] rules, by granting ... EU-headquartered banks who comply with the requirements under their respective home jurisdictions ... an exemption from the base risk retention requirements under the PR.”

General comments in response

Summarizing its overall view of the PR, ELFA said: “We are concerned about the potential harm which inappropriate risk-retention regulations could impose on the capital formation process and equipment finance companies ... as well as for their customers.”

“Many equipment lessors and lenders may not survive additional costs and limitations on funding which would significantly decrease the availability of [credit], increasing equipment finance costs and harming the US economic recovery.”

These concerns are echoed by the American Securitization Forum (ASF). It commented: “...Significant work still needs to be done to evolve the [PR] into workable solutions. What is at stake is the risk of significant reductions in the availability of auto loans, mortgages, student loans, credit cards, and commercial credit all across America.”

“Given that many engines of the US economy are still sputtering and unemployment remains extremely high, the ASF advocates strongly that these rules not overreach to attempt to 'fix' sectors of the securitization markets that did not see any losses during an extreme economic downturn...”

Bank of America, having echoed in its comment letter calls made elsewhere for specific modifications to the PR, stressed the risks of over-regulating the securitization market. It commented: “If the proposed rule is adopted without adjustment ... it may dislocate appropriate risk mitigation transactions and reduce credit availability to home owners, consumers, small and middle market businesses, and corporations.”

“The alternative to securitization is a banking market funded to a larger degree by deposits and wholesale funding ...Reversion to such a model, in which [banks] would increasingly finance long term assets ... with shorter term liabilities ... [would create] duration mismatching that has been viewed negatively by markets and regulators alike.”

Mayer Brown comments: “When enacted as required by the Dodd-Frank Act, the risk-retention rules will be the most far-reaching substantive regulations ever applied to the [ABS] market. It is impossible to predict the full extent of [their] impact.”

“However, it is quite easy to foresee that the [new] rules will contribute to the creeping transformation of securitization from a vibrant tool for credit creation and financial disintermediation into a burdensome and expensive form of finance.”

“... Retention of risk in an amount and in forms not otherwise required by a free market creates a financial cost [that] will inevitably fall on consumers in the form of higher costs of credit.”

Timetable to completion

The Dodd-Frank Act mandated completion of the rule making process on risk retention by April 15, 2011 (i.e. nine months from passage of the Act). It became clear some time ago that this timetable would slip.

At the time of writing the agencies are still targeting finalization of the rules before the end of June this year. Their effective date will be one year after finalization in the case of RMBS, and a year after that for all other securitization deals.

The Vehicle ABS Sponsors have called for a further draft of the rules to be briefly re-proposed for further public comment before they are finalized.

Other Securitization Enactments

While the risk-retention rules are by far the most significant development so far arising out of Dodd-Frank on the securitization front, the Act does contain some other provisions addressed to these deals.

Section 621 of the Act, inserting a new Section 27B into Securities Act 1933, mandated the SEC to propose new rules governing conflicts of interest affecting intermediaries involved in securitization deals. As with risk retention, these are currently awaiting finalization after the SEC issued proposals for detailed rules, in this case towards the end of 2011.

Those SEC proposals would prohibit sponsors and underwriters in ABS deals from engaging in further transactions that could give rise to a conflict of interest in relation to the relevant ABS within 12 months following closing of the ABS transaction. Exceptions are proposed in relation to hedging activities, liquidity commitments and bona fide market making activity.

Section 942 of the Dodd-Frank Act requires new SEC rules for the reporting of ABS transactions under the Securities Exchange Act 1934, and also for disclosure rules on compensation to brokers in such transactions. However, the Act contained no timetable for this SEC mandate, and the new rules have not yet appeared.

Section 943 of Dodd-Frank mandated the SEC to draw up regulations:

(a) requiring rating agencies to include in their ABS reports information on relevant representations and warranties (as defined by Section 3 9(a) 77 of the 1934 Act), and on enforcement mechanisms available to investors;

(b) requiring securitizers to disclose details of fulfilled and unfulfilled repurchase requests from investors, across all trusts which they have aggregated, “such that investors may identify asset originators with clear underwriting deficiencies.”

The SEC adopted final rules in January 2011 governing Section 943.

Section 945 required the SEC to issue rules requiring each ABS issuer to perform a review of the underlying assets during the term of the facility, and to disclose the nature of such reviews. Here again the SEC issued final rules in January 2011.

A number of provisions of Dodd-Frank governing rating agencies in general could eventually have a significant interface with ABS securitizations, because of the agencies' role in those deals. These will be the subject of a separate Asset Finance International report.

Glossary Of Terms Used

ABCP = asset backed commercial paper

ABS = asset backed security

“Agencies” refers to the Federal agencies (p. 10) involved in the risk retention proposals

ASF = American Securitization Forum

CMBS = commercial mortgage backed securities

“Conduits” (p. 9) are alternative securitization channels to ABS

DSCR = debt service coverage ratio

DHUD = Department of Housing and Urban Development

ELFA = Equipment Leasing and Finance Association

FDIC = Federal Deposit Insurance Corporation (the prudential regulator for some US banks and the retail deposit guarantor for all of them)

“Floor-plan loans” are advances to auto dealers to finance their stocks

GSEs = government-supported enterprises (usually referring to Fannie Mae and Freddie Mac in the RM market)

LTV = loan-to-value ratio (in mortgage markets)

MRR = minimum risk retention

PR = proposed rules (on MRR)

PV = present value (after discount) of future receivables

QAL = qualifying auto loan (p. 14)

QRM = qualifying residential mortgage (p. 00)

RM = residential mortgages

RMBS = residential mortgage backed securities

RV = residual value (of leased asset)

SIFMA = Securities Industry and Financial Markets Association

SPV = special purpose vehicle (p. 5)

“Vehicle ABS Sponsors” is a specially convened group of auto finance companies (p. 11)

“Waterfall” refers to the arrangements for prioritizing and distributing the flow of receipts into a securitization structure, among the respective classes of investors and the equity participant