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Credit Risk Retention Final Rule with Focus on Auto Issuers

On October 22, 2014, the Board of Governors of the Federal Reserve System, the Department of Housing and Urban Development, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Office of the Comptroller of the Currency and the Securities and Exchange Commission (SEC and collectively, the "agencies") jointly issued a final rule regarding risk retention by securitizers of asset-backed securities (the "Final Rule").[1] The Final Rule implements the credit risk retention requirements of Section 15G of the Securities Exchange Act of 1934, as added by Section 941 of the Dodd-Frank Act, and requires securitizers to retain not less than 5 percent of the credit risk of the assets (or "skin in the game") that collateralize any asset-backed securities transferred to a third party. The Final Rule also prohibits a securitizer from directly or indirectly hedging, including through third-party credit support (e.g., guarantees or letters of credit), or otherwise transferring such credit risk; however, there are certain exceptions available for qualifying loans, including auto loans that meet the underwriting standards set forth in the Final Rule. The Final Rule applies to both private and public securitization transactions.[2]

The agencies first issued the proposed rule in March 2011,[3] and re-proposed the rule in August 2013 (the "Re-proposed Rule").[4] The Final Rule takes effect one year after publication in the Federal Register for residential mortgage-backed securities and two years after publication for all other types of asset-backed securities, including autos. Pursuant to the Final Rule, a sponsor not otherwise exempt may satisfy its risk retention obligation by retaining an eligible vertical interest, an eligible horizontal interest or a combination of the two, as long as the percentage of the vertical interest and the percentage of the horizontal interest combined equal no less than 5 percent.

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1 Credit Risk Retention (final rule Oct. 22, 2014) (codified at 12 C.F.R. Part 43, 12 C.F.R. Part 244, 12 C.F.R. Part 373, 12 C.F.R. Part 1234, 17 C.F.R. Part 246, and 24 C.F.R. Part 267). *Available at* http://www.sec.gov/rules/final/2014/34-73407.pdf (last visited October 27, 2014).

2 Dodd-Frank added a definition of "securitizer" to the Exchange Act. A securitizer is either "(A) an issuer of an asset-backed security; or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer."

3 Credit Risk Retention (proposed rule Mar. 29, 2011). *Available at* http://www.sec.gov/rules/proposed/2011/34-64148.pdf (last visited October 27, 2014).

4 Credit Risk Retention (re-proposed rule Aug. 28, 2013). *Available at* http://www.sec.gov/rules/proposed/2013/34-70277.pdf (last visited October 27, 2014).

The Final Rule provides for a general exception (with a zero percent risk retention requirement) if the assets meet the underwriting standards set forth for qualifying automobile loans (QAL). Despite comments received from auto industry participants, for purposes of establishing the standard of a QAL, the Final Rule adopts the definition of "automobile loans" that was reflected in the Re-proposed Rule. As such, the definition of "automobile loans" includes first-lien loans on light passenger vehicles, including a minivan, van, sport utility vehicle, or light truck purchased for personal, family or household use, and excludes asset-backed securities backed by automobile leases, loans to finance fleet and other commercial automobiles, motorcycle loans and recreational vehicle loans. The agencies have taken the position that the types of automobiles excluded from the definition of "automobile loans" exhibit a higher risk profile and employ a different set of underwriting guidelines than those used for vehicles purchased for personal, family or household use and therefore cannot meet the QAL underwriting standards.

In order to satisfy the Final Rule's standard of a QAL, every loan must satisfy underwriting criteria that would indicate a low credit risk with respect to such loan. Despite auto industry participant comments addressing the dissimilarity between the proposed QAL underwriting criteria and current standard market underwriting practices, the Final Rule adopts the majority of the underwriting criteria contained in the Re-proposed Rule, including:

- **Ability to Repay:** The obligor has a debt-to-income (DTI) ratio of no more than 36 percent. The originator must verify an obligor's income and debt payments using standard methods.
- **Loan Terms:** The terms of the agreement must (i) provide for a fixed rate of interest for the life of the loan; (ii) provide for a level monthly payment amount that fully amortizes the amount financed; (iii) prohibit the obligor to defer repayment of principal or payment of interest; and (iv) require the obligor to make the first loan payment within 45 days of the date of the agreement.
- **Reviewing Credit History:** The originator has determined and documented that the obligor has at least 24 months of credit history. The Final Rule, however, provides a safe harbor from this requirement if the originator relies on a credit report that was obtained not more than 30 days before closing the loan and prepared by a national consumer reporting agency.
- **Down Payment Requirement:** The obligor paid from its personal funds and trade in allowance, if applicable, 100 percent of the taxes, fees and extended warranties in addition to 10 percent of the net purchase price of the automobile.

Once loans meet the requirements of the QAL standard, the Final Rule sets forth additional requirements for sponsors to avail themselves of the QAL exception: (i) the securitization is collateralized solely by loans of the same asset class and by servicing assets, (ii) reinvestment periods are not permitted, and (iii) the sponsor provides to potential investors prior to the sale of the asset-backed securities, or upon request to the SEC or its appropriate federal banking agency, if any, a description of the sponsor's determination of the qualification of the loans for purposes of relying upon the general exception. The Final Rule also requires that the sponsor retain the disclosures provided to investors in its records (and make available to the SEC or a federal banking agency regulator upon request) for three years after all asset-backed security interests issued in the securitization are no longer outstanding.

Additionally, in order to rely upon the QAL exception, the depositor of the auto loan securitization must also provide in advance of the sale of any asset-backed securities a certification to potential investors and upon request to its federal banking agency, if applicable. The certification must discuss the depositor-determined "effectiveness" of the depositor's internal supervisory controls over the process that was used to determine that the QALs meet the requirements of the Final Rule. The evaluation of the effectiveness of the depositor's internal supervisory controls must be performed within 60 days of the cut-off date for determining the pool of loans to be included in the securitization.

The sponsor will not lose the benefit of the QAL exception for a loan if it later determines that the loan did not meet all of the QAL requirements, the sponsor complied with the certification requirements, and (i) the failure to meet the QAL underwriting requirements is not deemed material or (ii) no more than 90 days after the determination that the loan does not meet the QAL underwriting requirements, the sponsor cures the QAL underwriting breach or repurchases the loan from the issuer at a price at least equal to the remaining principal balance and accrued interest on the loan as of the date of repurchase.

Combined with the requirements established by the recent issuance of the final rules regarding Regulation AB,[5] a sponsor may be subject to both risk retention and asset-level disclosure if the sponsor issues registered securities backed by assets that are not QALs and are issued in the public market. Sponsors of publicly issued registered securities backed by those QALs not subject to requirements to retain a specific risk percentage will still need to comply with applicable requirements for asset-level disclosure under Regulation AB.

This year, issuances of prime auto securitization transactions have been steady, and there has been a noticeable growth in subprime issuances as new players have entered the market. The Board of Governors of the Federal Reserve System expressed the view that the Final Rule should have little to no effect on the cost of credit for prime and non-prime auto securitizations, because such transactions are typically structured so that risk, in the form of the issued certificates, is retained in amounts generally adequate to satisfy the requirements in the Final Rule.[6] In the current market, securitizers of auto securitizations already retain significant risk in the underlying transaction in the range of approximately 2.5 to 6 percent. Risk is generally maintained with the depositor, which is usually a wholly-owned subsidiary of the sponsor. Given the fact that auto securitizers already retain significant risk and most likely will continue to do so instead of utilizing the QAL exception, it is difficult to understand what benefit the adoption of the credit risk retention requirements will have for investors in auto securitizations.

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5 Alston & Bird LLP *Finance Advisory: SEC Adopts the First Part of the Final Rules Relating to Regulation AB II. Available at* http://www.alston.com/advisories/SEC-adopts-AB-II/ (last visited October 27, 2014).

6 Credit Risk Retention (final rule Oct. 22, 2014) at p. 406.

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