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Risk Retention Update: Spring 2018

The "Risk Retention Rule"[1] has been in effect for a little over two years for asset-backed securities ("ABS") collateralized by residential mortgages, and for over one year for all other classes of ABS. While a general market consensus with certain aspects of the Risk Retention Rule has developed during this period in various asset classes, ABS securitizers and issuers continue to experience uncertainty in compliance for other areas and asset classes. King & Spalding has been at the forefront of the legal market in considering the Risk Retention Rule, and particularly in certain esoteric areas of the market.[2] In this update we explore below some important contrasts and distinctions among the traditional ABS asset classes that must comply with the Risk Retention Rule, certain clarifications under recent court cases and issues arising with certain esoteric asset classes gaining traction in the ABS market. We also discuss recent developments in the market satisfying the Risk Retention Rule for more traditional ABS asset classes and some trends we are seeing in the esoteric space.

CLASSES OF SECURITIZED ASSETS SUBJECT TO THE RISK RETENTION RULE

The Risk Retention Rule requires that securitizers, or "sponsors" of securitizations, "retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party".[3] The critical characteristic in determining whether an ABS security is subject to the Risk Retention Rule is whether it is "collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable)" for which payments "*depend primarily on cash flow from the asset*".[4] A self-liquidating asset is generally viewed as one that is capable, pursuant to its terms, of generating sufficient income by way of distributions and payment at maturity to return the ABS investment.

Esoteric Asset Classes with Ongoing Management Obligations. Esoteric asset classes, including aircraft, cell-tower, certain other leasing securitizations and whole business securitization are becoming a larger and increasingly popular segment of the ABS market. These esoteric asset securitizations fared much better than traditional mortgage-backed securities during the 2008-2009 market crisis. This may be due to the fact that the esoteric sector is focused more on specific tangible operating assets of the issuer as opposed to a pool of unrelated financial assets. Through active management and reinvestment, these assets are expected to continue to generate cash flow beyond the expected maturity of the securities issued in the securitization. Accordingly, the related sponsors typically anticipate significant residual value in excess of the value of the related securities.

We have joined other law firms active in these markets and other commenters to argue that certain esoteric asset classes, such as structured aircraft portfolio and "indenture-style cell-tower"[5] securitizations should not fall within the scope of the Risk Retention Rule precisely because of the significant residual value (generally well in excess of 5% of the issuance amount) in these transactions. In addition, we have also argued that the interest and principal payments on the securities issued are not serviced primarily by the financial assets commonly found in the respective pools, namely the lease contracts. Rather, the valuable equipment and real property commonly found in the asset pool are also critical to producing the expected cash flows relied upon in the securitization. Most critically, monetizing the value of this bundle of real and personal property and related short-term and longer-term leases requires active (and capable) management of both the financial assets (through active re-leasing) and the non-financial assets (through maintenance, refurbishment, and sale or disposition). Thus, we[6] as well as other practitioners have argued that a focus solely on the lease agreements existing at closing is a myopic view of the "whole" of the collateral pool, particularly in light of the compulsory active management required to maintain value and cash flow from this operating asset collateral. We further believe that a strong argument can be made that these leases are neither "self-liquidating," nor the "primary" means by which both interest and principal are ultimately paid on the notes, particularly in the light that the active re-leasing of the underlying assets may be considered the management of non-financial, rather than financial, assets.

Due to the lack of regulatory guidance with respect to these asset classes and also due to the economics of these transactions in which the sponsor or one of its affiliates typically expects to hold a significant residual interest well in excess of the 5% test, certain recent issuers have elected to comply voluntarily with the Risk Retention Rule via retention by the sponsor of equity of the issuing entity. This approach, while relatively straightforward, also can be structured to preserve the optionality to discontinue or modify compliance if the law is clarified so as to not require risk retention in the particular asset class. This voluntary compliance is best understood as precautionary in nature, given regulatory uncertainty, and we have utilized various approaches in structuring this voluntary compliance for our clients.

We believe that similar arguments and analysis should be applied to securities issued in franchise royalty securitizations—a category of "whole business securitizations"—in asserting that issuances under these securitizations should also not be considered "asset-backed securities" for purposes of the Risk Retention Rule. In a typical franchise royalty securitization, the underlying asset pool consists of existing and future franchise agreements and IP licenses (and their associated royalty payments). These operating assets require a competent sponsor/manager (generally, the same party) to undertake *substantive, active and ongoing duties* to exploit and develop the underlying assets. These are hardly self-liquidating assets that are capable, on their own, of producing sufficient value to return the total interest and principal on the securities that have been issued. The management obligation in these transactions is assumed under a franchise agreement, in which a competent party (typically an affiliate of the issuer) undertakes, as franchisor, the *substantive, active and ongoing duties* to the franchisees and receives the franchise fees, the cash flow from which is being securitized. Notably, these fees are not "hell-or-high-water"; if the franchisor's duties are breached, the franchise/license royalty inflows could possibly be reduced and potentially eliminated altogether. Thus, issuers are well incentivized to appoint a competent manager to service the pool of securitized assets—essentially, to run the ongoing business. The importance of a competent manager is further highlighted by the requirement often sought by purchasers and imposed by certain rating agencies to appoint a back-up manager capable of promptly transitioning into this role if the manager fails to sufficiently perform its obligations.[7]

Due to the highly active role of the manager described above, it is our view that the securitized assets in franchise royalty securitizations should generally be recognized as *not self-liquidating* and that they may not even constitute *financial assets*.

Other Esoteric Asset Classes. While we believe that properly-structured indenture-style cellular tower, aircraft, and whole-business securitizations may reasonably be viewed as being outside the scope of the Risk Retention Rule, properly interpreted, other esoteric asset classes may not be so favorably situated. For example, the cash flows in shipping container securitizations rely by their own terms primarily on self-liquidating leases. While re-leasing of the containers following the initial lease is an important piece of the cash flow analysis, these transactions often do not require the same level of active pool management.

Consumer asset securitizations are taking a larger market share due to the consumer payment priority and potential for large issuances. Wireless handset securitizations are backed by installment contracts generated by cell phone users who elect to finance their cell phone purchases over a number of years. These installment contract receivables can reasonably be construed as "self-liquidating financial assets" because the initial contract terms are sufficient to make payment in full on the securitization notes without active solicitation of renewed or new contracts.

While the relevant governmental agencies and the courts have provided minimal guidance on specific compliance requirements, a recent decision of the United States Court of Appeals for the District of Columbia Circuit has interpreted certain terms of the Risk Retention Rule in a manner that removes a specific class of assets—namely open-market CLOs—from its scope.[8] The Risk Retention Rule represents, among other things, the view of the Securities and Exchange Commission, the Board of Governors of the Federal Reserve System and the other applicable regulators that the collateral manager of an open-market CLO is the "securitizer", as the "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," and the District Court had upheld this view. On February 9, 2018, the Circuit Court reversed (the "LSTA Decision"), and ruled that collateral managers in open-market CLO transactions are not subject to the Risk Retention Rule or any related regulations, based, among other things, on an analysis of whether the sponsor or securitizer had "transferred" the assets into the issuing entity.

The Circuit Court first asserted that a "securitizer" under the Risk Retention Rule must, as a matter of English usage, at some point in time have had a possessory or ownership interest in the assets that is transferred, directly or indirectly, to the issuer because, otherwise, it would have no interest to "retain." A collateral manager of an open-market CLO, on the other hand, is not subject to the risk retention requirements because it merely directs and consummates asset acquisitions on behalf of the issuer without ever having had any ownership interest in the transferred assets. The Circuit Court pointed out that its reasoning would of necessity not apply to so-called "balance-sheet CLOs" in which the financial institution or asset manager originating or owning the loan assets is involved in the organization and initiation of a securitization. We are hopeful that the LSTA Decision will pave a path towards establishing the absence of a "transfer" by a sponsor as an exemption from the Risk Retention Rules in a broader array of asset classes and transactions in which sponsors play a more limited role in structuring the transaction and/or originating the assets.

THE "MENU" OF OPTIONS AVAILABLE TO SATISFY RETENTION REQUIREMENTS

The Risk Retention Rule allows for some flexibility in applying retention mechanisms through multiple standard approaches as well as asset-specific options based on relevant market practices. A sponsor or securitizer that is subject to the Risk Retention Rule has the option to retain an, "eligible horizontal residual interest", "eligible vertical residual interest", or any combination of the two, referred to as an "L-shaped Interest." We have seen in the market a number of interesting variations that issuer have developed in implementing these variations in the Risk Retention Rule.

At the outset, securitizers seemed to prefer retaining a vertical interest due to the simplicity of dealing with nominal values. But in practice, the retention options chosen by securitizers has varied broadly based on the specific class of ABS, with many issuers choosing a horizontal interest for simplicity and maximization of securitized proceeds in transactions with significant existing residual value, at least when disclosing the fair valuation of such horizontal interest did not create undue incremental complexity.

Working within the specific regulatory guidance, certain hybrid mechanisms have evolved in the market, particularly in the CLO space. Two of the structures commonly used to satisfy retention requirements include creating stand-alone businesses capitalized by third-party investors known as "capitalized manager vehicles" or "CMVs" and using a more cost efficient self-capitalized investment unit known as a "majority-owned affiliate" or "MOAs". CMVs demand a substantial amount of time and effort, but allow more investor involvement, whereas the MOAs, while simpler, will likely be practicable only for the most highly capitalized CLO managers. Regardless of the structure chosen, the vertical interest form of retention appears to be the most feasible means of compliance because it allows thinly capitalized managers to retain the least amount of capital and allows third-party investors, who otherwise could not invest (even indirectly) in the below-investment-grade horizontal interest, to finance CMVs. Vertical interest retention would also permit CLO managers to forego the extensive disclosure requirements that accompany horizontal interest retention. However, as more transactions are structured as open-market CLOs to escape the Risk Retention Rule, these methods will become less relevant in the CLO space. The applicability of open-market methods to other asset classes remains to be seen.

CONCLUSION

As securitizers continue to implement structures that adhere to or carefully seek to place a transaction outside the scope of the Risk Retention Rule, issuers will continue to develop new structures. The feasibility of transferring risk to third-parties will be dictated by investor appetite for the most subordinated tranche of ABS. Where sponsors (or their majority-owned affiliates) must retain credit risk themselves, the retention method will likely be dictated by their capitalization, their ability to raise financing and their preferences regarding the feasibility of fair value disclosures of the retained interest. Market participants are obviously looking forward to effective regulatory and/or judicial clarifications or the easing of these restrictions. The recent LSTA decision may mark the beginning of that easing, and we hope for additional interpretations in the Risk Retention Rule that provide clarity and predictability. We look forward to working with our clients in fashioning creative and efficient means of compliance, as developments in the law and the market emerge.

This article was prepared by the King & Spalding LLP specialty finance and securitization team, including Michael Urschel, Terry Novetsky, Jeff Misher, Matthew Sandiford, Anthony Mechcatie, George Williams, Jennifer Tian, Adam Ghebrekristos and Bert Eidson, and Matthew Roberts, a 2017 King & Spalding LLP summer associate. King & Spalding's specialty finance professionals handle receivables financings, structured finance and securitization transactions, in bank-funded, privately-placed and capital markets-issued form. Our firm has represented the structuring banks and/or issuers in some of the most high-profile specialty securitizations and "whole business" securitizations in the market.

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[1] 17 C.F.R. Part 246 (2017).
[2] *See King & Spalding LLP, et. al., Application of the U.S. Risk Retention Rules to "Indenture-Style" Cellular Tower Securitizations*, White Paper (May 12, 2017), "Indenture-style" cell tower securitizations are distinguished from "CMBS-style" cell tower securitizations, in which "a back-to-back mortgage loan structure is interposed between the underlying cellular tower collateral and the issued notes."
[3] 17 CFR § 246.1(a) (2017) (emphasis added).
[4] 15 U.S.C. § 78c(a)(79) (2012) (emphasis added).
[5] *See* footnote 3, above
[6] *See* footnote 3, above
[7] Kroll Bond Rating Agency, TGIF Funding, LLC – Series 2017-1 Senior Secured Notes New Issue Report at 17.
[8] *Loan Syndications & Trading Ass'n v. S.E.C.*, No. 17-5004 (D.C. Cir. Feb 9, 2018).