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Impact on the Equipment Finance Industry of the Asset Backed Securitization Provisions in House Financial Regulatory Reform Legislation (H.R. 4173)

The ELFA is the trade association that represents companies in the $600 billion equipment finance sector engaged in the financing, utilization, and investment of and in capital goods. This industry provides capital to business, government and the non-profit sector for investment in capital plant and equipment. ELFA members are the driving force behind the growth in the commercial equipment finance market and contribute to capital formation in the U.S. and abroad. The ELFA has over 600 members including manufacturers, independent and captive lease and finance companies, banks, financial services companies, broker/packagers, investment banks, and service providers.

The proposed '33 Act sections 29(a)(1) and 29(a)(2) of the House passed financial regulatory reform bill (H.R. 4173) would require a creditor or securitizer to "retain an economic interest in a material portion" of the credit risk on **ANY LOAN OR ANY ASSET** [emphasis added] that is transferred, sold or conveyed by such creditor or used to back an issuance of asset-backed securities except as the appropriate agency may reduce or exempt, but only if the agency determines that each such loan meets characteristics that "reflect loans with reduced credit risk, such as...a securitization in which a third-party purchaser specifically negotiates for the purchase of the first-loss position and provides due diligence on **ALL INDIVIDUAL LOANS** [emphasis added] in the pool prior to the issuance of the asset-backed securities".

This "all individual loan" requirement is problematic for several reasons:

- Investors and rating agencies require credit enhancement on a pool basis, because no one knows which contracts in the pool will default--and when a contract defaults, the loss on that contract most likely will exceed 5% of the original discounted principal balance of that contract. Consequently, 10% credit enhancement on a $10MM pool typically will result in $1MM available to cover losses, no matter how large and no matter how many contracts, until the $1MM is exhausted.
- The vast majority of contracts will never default. Requiring credit enhancement on every contract will place a securitizer's capital needlessly at risk, while the investors and rating agencies will attribute little value to the "unnecessary" credit enhancement for every contract.
- Investors will take the 5% enhancement required by the House legislation and then require more, to cover the risk described in the first bullet above. To the extent that the aggregate enhancement exceeds 10% (the current industry standard for maximum credit enhancement, consistent with "true sale" opinions required by investors, rating agencies and originators' accountants), then there will be a

tension between congressionally mandated enhancement and the demands of the marketplace.

- Since the height of the subprime mortgage securitization boom, approximately 2004-06, investors in asset-backed and mortgage-backed securities have become less reliant on rating agencies and more aware of potential risks. Our experience with equipment-backed financings during 2008 and 2009 has spotlighted that investors uniformly have been conducting more intense due diligence of the transaction structure, the degree of credit enhancement and the underlying assets. Rather than having Congress prescribe a uniform level of credit enhancement, it may be appropriate to authorize federal regulatory agencies to regulate credit enhancement for more risky securities, in a manner which coincides with measures which the investment community is imposing on similar transactions.
- The due diligence requirement for all loans flies in the face of one major advantage of securitization: obviating the need for diligence on all assets in the pool--especially prior to closing and funding. Diligence after closing, with a seller repurchase obligation for nonconforming assets, would be a more sensible suggestion.

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