Meeting between Federal Reserve Board Staff
and Representatives of the American Securitization Forum (ASF)
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Summary: Staff of the Federal Reserve Board met with representatives of ASF to discuss the proposed rules to implement the requirements of section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Representatives of ASF provided a presentation of their overall views on the proposed risk retention rules. A copy of the handout provided by ASF at the meeting is attached below. The handout formed the basis for discussions at the meeting and summarizes the issues discussed.

Risk Retention Proposed Rules

Accounting Consolidation, Premium Capture and ABCP Compliance

June 2011

Accounting Considerations

- **Vertical** – 5% of each tranche
  - Premium capture (discussed below) aside, accounting sale <u>can be achieved</u> even if issuer and servicer are affiliated
- **Horizontal** – 5% of par value of ABS; first loss position
  - Premium capture aside, accounting sale <u>cannot be achieved</u> if issuer and servicer are affiliated
- **L-Shaped** – 50/50 split of horizontal/vertical retention
  - Premium capture aside, accounting sale likely <u>cannot be achieved</u> if issuer and servicer are affiliated
- **Representative Sample**
  - Premium capture aside, accounting sale <u>can be achieved</u> even if issuer and servicer are affiliated
  - However, not likely to be used in its current form

Premium Capture Rule

- If excess spread is monetized, the premium received must be placed into a separate "premium capture cash reserve account" ("PCCRA") to absorb losses first
- Effectively adds onto the Dodd-Frank 5% risk retention requirement the entire value of ABS issued over par
- As drafted, the PCCRA:
  - Eliminates upfront returns by sponsors
  - Does not take into account the costs of origination
  - Interferes with ability to hedge interest rates and thus rate-lock borrowers
  - Unduly affects low to moderate income borrowers
- PCCRA will eliminate incentives for banks to securitize residential and commercial mortgages

Premium Capture Rule

- Premium Capture Formula
  - Funded amount would be the difference between (i) the gross proceeds from all sold ABS; and (ii) the *par value* of all issued ABS (not counting retention)
    - At least one regulator believes formula is based on *market value* and the sole purpose of the PCCRA is to ensure that the risk retained by the sponsor is worth at least 5% of the market value of issued ABS
  - **Example:** $100 UPB pool, with $95 sold and $5 retained as first loss
    - Assume $102 proceeds, including $99 for sold ABS (104.21% * $95) and $3 for retained ABS (60% * $5)
    - Under the rule as written:
      - PCCRA = $99 - (95% * 100) = $99 - $95 = $4
    - Under the rule as interpreted by at least one regulator:
      - PCCRA = $99 - (95% * 102) = $99 - $96.90 = $2.10
      - Thus, market value of retained ABS + PCCRA = $5.10 retention (or 5% of MV of ABS)

PCCRA Consolidation Issues

- As written, PCCRA may result in balance sheet consolidation regardless of retention form employed
  - Adding PCCRA to vertical slice would cause consolidation in virtually all cases
  - Adding PCCRA to representative sample retention may also cause consolidation – meaning, PCCRA could cause consolidation <u>on its own</u>
- However, if alternative interpretation was adopted, consolidation analysis of vertical slice retention would not be affected by PCCRA
  - Meaning, sale accounting could be achieved

QRM Exemption: Blended Pools

- QRM definition is tight
  - Only 20% of GSE loans would meet requirements
- QRM exemption only available if all loans are QRMs
  - This requirement effectively splits the residential mortgage securitization market into QRM transactions and non-QRM transactions
- Will create liquidity problem
  - It may not be possible for sponsors to originate enough QRMs to generate the critical mass of loans necessary for economically efficient securitizations, which will increase the cost of lending
- ASF commingled pool proposal would alleviate this concern
  - Allow pools in which some portion but not all of the loans meet the QRM criteria, and then ratably reduce 5% risk retention by the proportion of the total pool that meets the QRM standards

QRM Servicing Standards

- No legislative intent
- Piecemeal approach – would only cover a small percentage of borrowers
- Illogical approach – would impose standards for highest quality borrowers, those that need regulation the least
- Setting forth servicing standards in loan documents will have unintended consequences
  - Moral hazard
  - Would effectively create a private right of action for borrowers
    - One foreclosure action could call into question the servicer’s policies and procedures for all QRM loans, potentially causing significant losses to institutional investors

European Rules

- Compliance with European Union CRD Article 122a
  - Applies to EEA credit institutions investing in securitizations
    - So both retention regimes could apply
    - Need harmonization between regimes
  - Forms of Retention
    - "L-Shaped" option does not exist in menu provided under EU rules
    - Article 122a permits retention synthetically, on a contingent basis or through derivatives
  - No CMBS specific rules
  - No Premium Capture rule

FDIC Inconsistencies

- FDIC Safe Harbor requires risk retention in the form of vertical slice or representative sample
  - FDIC rule does not take into account characteristics of different assets
  - FDIC rule ignores securitization features such as OC and seller's interest
  - Representative sample is not consistent across rules
- FDIC rule is currently effective but Dodd-Frank mandates one or two year implementation period for risk retention rules
- FDIC's recent CMBS transaction did not comply
  - "The pilot program is consistent with the [Safe Harbor], except for certain limited differences necessitated by the origin of the collateral and the absence of information available from the failed banks"
  - No vertical or representative sample retention employed

ABCP Agenda

- **Overview, observations and recommendation**
- **Risk retention considerations**
- **Industry response and suggested modifications**

The ASF ABCP Subforums support risk retention as a tool to promote safe and sound underwriting

- **We applaud the various agencies in their effort to distinguish among the different types of securitizations that provide meaningful benefits to the real economy and to the availability of credit**
  - The NPR explicitly recognizes that the are differences in (a) market protocols, (b) product design and risk allocation, (c) investor demands and (d) issuer interests

- **We do, however, have a number of methodological concerns as well as technical considerations with the framework as proposed in the NPR**

Methodology	1. As formulated, the NPR would make it difficult (perhaps even impossible) for administrators to avail themselves of the 'eligible ABCP conduit' option without substantive changes to existing business practices that could adversely affect the amount of customer funding 2. The other risk retention alternatives would require material changes to the basic structure and objectives of ABCP conduits imparting meaningful transactional differences for all of the major ABCP constituents: issuers, administrators and investors 3. Program wide credit enhancement provided to ABCP conduits should be explicitly recognized as a permitted form of risk retention in the final rule 4. Originator-Sellers to ABCP conduits should be permitted to use all forms of risk retention generally available under the NPR
Technical considerations – Eligible ABCP Conduits	1. Seller disclosure 2. Multiple Originator-Sellers 3. Direct Origination of assets 4. Obligation of sponsor to monitor originator-seller compliance

The ABCP Subforums are proposing an unfunded risk retention alternative for certain highly supported ABCP conduits

- **The ABCP sub-forum in its comment intends to propose a limited number of modifications to the current NPR that are designed to ensure robust 'risk retention' on the part of the ABCP conduit administrators while preserving the core aspects of ABCP structures that are highly important to both issuers and investors**
  - ≥ 100% backstop liquidity (unfunded)
  - ≥ 5% program wide credit enhancement facility (unfunded)
  - No market value dependency for ABCP repayment
  - No requirement to disclose seller names

Experience based	1. The most meaningful sector within the ABCP market has operated in this manner for decades prior to and through the financial crisis 2. We are not aware of a single dollar of investor loss (including the crisis) for the above criteria
Product based	1. Unlike other securitizations, investors materially benefit from more than 100% bank provided liquidity support and at least 5% program wide credit enhancement 2. Investors are not primarily dependent on the underlying transaction cash flows 3. The shorter tenor of ABCP allows investors to efficiently exit their investment with little to no market risk
Market developed disclosure	1. Seller disclosure *not* required 2. Monthly reporting to follow ASF Reg AB II recommendation which incorporates explicit investor input and received explicit investor support
FSOC aligned	1. Aligns incentives without changing the basic structure and objectives of securitization transaction
Regulatory precedent	1. Article 122A of the Committee of European Banking Supervisor Capital Requirements Directive permits the use of unfunded program wide credit enhancement to satisfy risk retention requirements

American SECURITIZATION FORUM®

Risk Retention for ABCP Conduits

ABCP provides a vital source of financing to a wide variety of businesses

- Since the multi-seller ABCP markets' inception almost 30 years ago, these programs have provided a vital source of low cost working capital for businesses of all kinds in both the U.S. and globally.

ABCP has included risk retention by the sponsoring banks since its inception

- ABCP conduits funding businesses today typically include risk retention well in excess of 5% of the risk of the assets. This risk is retained through a variety of support facilities most often provided by the sponsoring bank in the following forms:
  - Transaction specific liquidity facilities – conditional[1]/unconditional.[2]
  - Program-wide credit enhancement facilities typically in the form of an unfunded letter of credit (or similar form of direct credit substitute).

[1] Amount of funding subject to an asset quality test
[2] Amount of funding not subject to an asset quality test

Risk Retention for ABCP Conduits

Investors in ABCP rely on this risk retention provided by the credit support providers

- ABCP conduits have unique structures within the securitization markets.
  - Investors in ABCP purchase debt (cp) with short-tenored maturities.
  - Unlike term ABS investors, ABCP conduit investors' primary source of repayment are the support facilities as the assets financed do not provide sufficient timely cashflows to repay the maturing ABCP.

Investors in this market with 100% liquidity support do not need changes in risk retention

- There have been no losses suffered by ABCP investors on programs with these support arrangements even during the recent financial crisis.
- Imposing risk retention requirements on these programs beyond sponsoring bank credit support would not advance the purposes of Dodd-Frank.
  - Due the substantial financial support provided by ABCP conduit sponsors (100% liquidity and program wide credit enhancement), banks are highly incentivized to finance assets that are evidenced by high quality underwriting and servicing
- There are also a number of requirements outlined in the recently released NPR that are inconsistent with long established market practices and pose significant issues for this market.

Risk Retention for ABCP Conduits

The risk retention NPR that was recently released by the Federal Regulators ("Agencies") outlines a number of options available to accomplish the goal of risk retention both for ABCP conduits as well as other securitizers in the market.

- **Eligible ABCP Conduit Option**
- **Horizontal Risk Retention**
- Vertical Risk Retention
- L-Shaped Risk Retention
- Representative Sample

Eligible ABCP Conduit Option

No ABCP conduit will qualify for this exemption due to the very narrow definition as drafted:

- Unable to fund transactions for multiple originators/sellers.
  - Some transactions funded in multi-seller ABCP conduits include multiple originators from a common corporate family which would not be permitted to be funded in an "eligible" ABCP conduit.
- Unable to fund transactions for sellers where all of the ABS interests were not either retained by the sellers or sold to ABCP conduits (i.e., the seller has sold other risk tranches in the transaction to non-conduit investors).
  - This would preclude ABCP conduits from funding transactions issued out of a master trust.
  - This would also preclude ABCP conduits from funding transactions where other senior and mezzanine tranches are funded by institutional investors (e.g., banks and insurance companies) that are not ABCP conduits.
  - This is contrary to the overall risk retention requirements where sellers are not limited in terms of who they sell tranches to provided they retain a risk tranche pursuant to the requirements.

Eligible ABCP Conduit Option

No ABCP conduit will qualify for this exemption due to the very narrow definition as drafted:

- Sponsor duty to monitor sellers' compliance.
  - To the extent that an ABCP conduit sponsor were to rely on originator/seller risk retention as set forth in the proposed rules, its duty to monitor compliance should be limited to assuring that transaction documents contain covenants obligating the originator/seller to comply with risk retention requirements and report any non-compliance to the sponsor.
  - The proposed rule should be modified to make clear that imposing such requirements would satisfy the sponsor's duty to monitor compliance.

Eligible ABCP Conduit Option

No ABCP conduit will qualify for this exemption due to the very narrow definition as drafted:

- Indirect retention by originator/seller.
  - Frequently, ABCP conduit transactions are structured so that originator/sellers sell their entire interest in the securitized receivables to an intermediate SPV in exchange for cash consideration and an equity interest in the SPV.
  - In these transactions, the amount advanced by the ABCP conduit against the securitized assets would be less than 95% of the amount of the assets, but the directly retained subordinate interest is held by the intermediate SPV rather than the originator/seller.
  - For so long as the originator/seller holds its equity interest in the SPV, it is exposed to the risk of the assets. Such indirect risk retention should satisfy the policy goals of the regulation and be permitted in the final rule.

Eligible ABCP Conduit Option

No ABCP conduit will qualify for this exemption due to the very narrow definition as drafted:

- Acquisition and Direct Origination of Assets by Intermediate SPVs.
  - As drafted, the proposed rule would require originators/sellers to sell the assets funded by the ABCP conduit to an intermediate SPV.
  - Occasionally, the customer formed SPV will directly fund the assets (frequently with an equity contribution to the SPV by the owner of the SPV, which also acts as collateral manager or servicer).
  - Also, the SPV may occasionally acquire the financed assets directly in connection with the sale of the assets of a business or other transaction.
  - For so long as the entity owning the equity interest in the SPV directly or indirectly retains the required risk of the financed assets, these transactions should qualify to be funded in an Eligible ABCP conduit.

Eligible ABCP Conduit Option

No ABCP conduit will qualify for this exemption due to the very narrow definition as drafted:

- Multi-Entity Conduit Structures.
  - Often in cross-border transactions, an ABCP conduit sponsor will create a separate entity that it also sponsors to enter into a customer transaction for legal reasons. The U.S. ABCP conduit will on-lend the proceeds of the ABCP to this entity which in turn will finance the customer's assets.
  - In these structures, liquidity facilities may be provided to the lending vehicle rather than the ABCP conduit.
  - Such related entities should be treated collectively as an ABCP conduit for purposes of risk retention.

Eligible ABCP Conduit Option

Definitional Issues with Eligible ABCP Conduit Option

- Based on the questions raised in the NPR, it appears that the Agencies' primary objective in these requirements was to avoid allowing SIV and securities arbitrage programs to qualify.

Is our understanding of your primary policy objective correct?

Proposed Solution:

- The 100% liquidity requirement alone would have excluded SIVs.
- Inclusion of covenants within the documentation for transactions funded in an Eligible ABCP conduit should satisfy the sponsor's duties with regard to monitoring compliance.
- Flexibility should be allowed for indirect risk retention by originators/sellers as described as well as allowing for the originator/seller or its wholly owned SPV to have risk retention.
- Related entities should be viewed collectively for purposes of the risk retention rule.

Would this meet the Agencies' objectives?

Eligible ABCP Conduit Option

Punitive Limitations on Sellers

- In addition, Eligible ABCP Conduits, as currently drafted, would be unable to fund transactions for sellers who failed to assume risk in the transaction using the horizontal risk retention method.

Was there a specific policy objective of limiting sellers to eligible ABCP conduits to only one form of possible risk retention while allowing sellers who financed themselves through the term ABS markets to have a variety of options?

Eligible ABCP Conduit "Exemption"

Required Disclosure

- The NPR also provides that sponsors of Eligible ABCP conduits who choose to use this option would be required to disclose the names of all sellers into the program to its investors.
- Market participants (including sponsors, dealers and investors) recently spent significant time discussing the enhancements to reporting proposed under Reg AB II by the SEC.
- There was and continues to be broad agreement across the market that while standardization and minimal standards of reporting are appropriate, the inclusion of seller names in the reporting is neither necessary nor desired, specifically:
  - **Investors** in ABCP programs **do NOT want this change** in reporting requirements.
  - The sellers into the ABCP conduit market also do not want their names disclosed to the investors as they value this anonymous funding source.

- We appreciate the Agencies' attempt to accommodate the ABCP structure as distinct from other ABS structures and to provide for a risk retention option tailored to this market. Continuation of this standard as a requirement will result in **NO** ABCP sponsors choosing to use this option as they would lose both customers and investors should they choose this form of risk retention.

Assuming that this was not the desired result of the proposed rules, the willingness of industry participants to agree to standardized investor reporting and given the investors' lack of desire for this change in reporting, how critical is this requirement for the Agencies?

Horizontal Risk Retention

Overview of Current Market Risk Retention Structures

Horizontal risk retention in ABCP conduits as currently structured typically takes a variety of forms:

- Unfunded letter of credit typically provided by the sponsoring bank and frequently sized at 5%.
  - Some conduit sponsors also include a small first loss layer subordinate to the retained letter of credit.
  - ABCP conduits supported by an unfunded letter of credit also have access to 100% liquidity facilities typically also provided by the sponsor bank and other institutions meeting the definition of regulated liquidity provider in the proposed rule, but these liquidity facilities are frequently subject to asset quality tests.

- Alternatively, some programs are structured with 100% unconditional liquidity.
  - Bank sponsored.
  - Non-bank sponsored.

Horizontal Risk Retention

Sponsoring banks already take more than 5% risk of the assets in these structures

- The supporting bank assumes far more than 5% of the economic risk of the transactions that are funded by the ABCP conduits - albeit in an unfunded form.
  - This risk retention has served the marketplace extremely well as investors have not incurred a single dollar of loss in structures that benefit from 100% liquidity support plus program wide credit enhancement
- Banks providing these support facilities, in recognition of the risks retained therein, have been required to hold regulatory capital against these exposures for years.
- We are not aware of any failure to fund under these support facilities throughout the almost 30 years of this market's existence.
- European risk retention regulations (CRD2) allow for risk retention in synthetic or unfunded form.
- Funding risk is distinct from the risk retention issue in the context of these programs.

Horizontal Risk Retention

Horizontal Risk Retention as proposed presents the following issues for ABCP:

Unfunded risk retention prohibited

- ► Letters of credit and liquidity commitments are the predominant form of risk retention in these ABCP programs are not specifically permitted under the proposed rules.
- ► The NPR as drafted does not allow for the risk retention exposure to be taken on an unfunded basis as has been historically and continues to be the preferred structure for this market.

Presence of more subordinate risk tranches sold to third party investors

- ► The requirement that this horizontal risk retention be at the first risk of loss poses problems for those ABCP conduits with Expected Loss Notes which are used to accomplish an accounting objective and are of minimal size no greater than 1% of the overall ABCP conduit.
- ► This tranche is not an ABS interest and also is not used for the benefit of the ABCP investors.

Horizontal Risk Retention

Proposed Solution:

- ABCP conduits would be permitted to hold the 5% required horizontal risk retention in an unfunded form of letter or credit, liquidity or other structure designed to fully cover the credit risk of the assets.
- Program support providers to ABCP conduits that have these Expected Loss Notes no greater than 1% would be required to add the size of the Expected Loss Notes to the 5% requirement.

What is the Agencies' view of these proposed solutions for ABCP conduits which would allow the ABCP conduit market to continue to operate as it has with regard to retained credit risk for almost 30 years?

Other Issues/Questions with Risk Retention Proposal

Effective Date for Eligible ABCP

- As proposed, all transactions would need to comply with the requirements as outlined in order for the sponsor to qualify to use the "eligible" ABCP risk retention option.
- Sponsors would have no contractual right to amend documents to ensure compliance prior to the termination of any existing commitment.

Proposed Solution

- Sponsors could be held to the qualification criteria for all new transactions funded and for any increases or renewals of existing transactions closed after the effective date of the new rules.

What do the Agencies think of this proposal as a workable solution? Would it meet the Agencies' objectives?