Structured Finance Industry Group

APPLICATION OF CREDIT RISK RETENTION RULE TO REVOLVING MASTER TRUSTS

JANUARY 17, 2014

AGENDA

1. **Recap of Key Points from 12/16/13 Meeting – Modest Changes to Make the Rule Significantly More Workable for Major Segments of the Master Trust Market**
   (Slides 3-6 from our 12/16/13 slide desk)

2. **Seller's Interest Form of Risk Retention: Treatment of Subordinated Seller's Interests**
   (Annex A to this Agenda)

   - The seller's interest in virtually every master trust features some form of subordination to the investor interests.
   - Each such form should be recognized as an available form of risk retention under the final rule.
   - If the joint regulators seek to treat different forms of subordination differently, the distinction should be based on the characteristics of the seller's interest taken as a whole. Credit subordination should not be the sole determinant. See Annex A to this Agenda.

3. **Horizontal Risk Retention Options for Revolving Master Trusts**
   (Slides 8-10 from our 12/16/13 slide deck)

   - Many forms of horizontal risk retention commonly used in current master trust structures cannot satisfy the standard or the special horizontal risk retention option as proposed.
   - If one or more forms of subordinated seller's interest are treated like horizontal residual interests under the rule, this problem will be exacerbated because subordinated seller's interests are no better suited to satisfy these proposed horizontal risk retention options.
   - It is critical, therefore, that the special horizontal risk retention option for master trusts be revised as set forth in SFIG's comment letter to accommodate the additional forms of horizontal risk retention already used in the market, as well as any form of subordinated seller's interests that is treated like a horizontal residual interest under the rule.

4. Valuation of, and Measurement Dates for, Subordinated Seller's Interests and Horizontal Interests in Master Trusts

(Slides 12-14 from our 12/16/13 slide deck)

- A fair-value determination for subordinated seller's interests and horizontal interests in master trusts would be burdensome, especially if sponsors are required to perform such calculations monthly or to re-value previously-issued ABS interests on the closing date for each new issuance.

- We believe that a face-value measurement would better balance the competing considerations in the context of master trusts, so long as the master trust does not monetize excess spread.[1]

- If our request to measure subordinated seller's interests and horizontal interests on a face-value basis is not adopted, and if the Joint Regulators determine that a re-valuation of such interests is required, either monthly or on each new issuance date, we request that the alternative valuation method outlined in our comment letter – using the "invested amount" of the related ABS interest – be adopted.

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[1] As noted on slide 13 of our 12/16/13 slide deck, we believe a fair-value measurement would be appropriate in the case of a residual interest in series-level excess spread. However, given the complexity of valuing excess spread, we believe most sponsors will elect not to claim credit for such interests. We believe, therefore, that the final rule should allow sponsors to disregard their residual interest in excess spread and still receive credit for other horizontal interests that it retains.

ANNEX A

Forms of Seller's Interests

- ***Pari Passu* Seller's Interest:** Virtually all master trusts allocate principal collections between the investor interests and the seller's interest on a *pari passu* basis only during revolving periods, and on a fixed allocation basis during other periods, including scheduled principal accumulation or scheduled principal amortization periods. This fixing of allocations of collections to the investor interests operates as a form of subordination of the seller's interest.

- ***Pari Passu* Seller's Interest with Subordination of Collections:** In some master trust transactions, collections that are allocated to this *pari passu* seller's interest may first be applied to cover shortfalls, if any, remaining after application of collections allocable to the investor interests.[2]

- **Seller's Interest Comprised of Two Parts: A *Pari Passu* Seller's Interest and a Series-Level Subordinated Seller's Interest:** In some other cases — a typical floorplan securitization, for example — the seller's interest is comprised of two parts:

  (i) one part is a typical *pari passu* seller's interest, and

  (ii) the other part is a series-level subordinated seller's interest, which is issued in an amount equal to the available subordinated amount for a series and functions as credit enhancement for that series by absorbing losses allocated to the related investor interests before the investor interests are themselves affected (see slide A-7 in our 12/16/13 slide deck).

- In all three cases outlined above, the *pari passu* seller's interest adjusts for fluctuations in the outstanding principal balance of the trust assets, while the series-level subordinated seller's interest generally does not.[3] Notably then, the *pari passu* seller's interest acts as a cushion by absorbing seasonal fluctuations in the portfolio and dilutions (returns). By the terms of the seller's interest, therefore, the seller is obligated to fund any and all amounts of principal receivables that arise in the trust accounts from day to day in excess of the aggregate investors interests.

- This obligation to absorb seasonal and other fluctuations in the principal balance of the portfolio represents a fundamental difference from any form of horizontal interest in the trust and, regardless of any subordination of collections, the seller's obligation to fund such amounts operates itself as a significant mechanism to align the interests of the securitizer with those of investors.

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[2] Collections allocable to the seller's interest may be made available to cover shortfalls in interest, principal or both, or to cover loss amounts allocated to investor interests.

[3] The series-level subordinated seller's interest is typically issued in a fixed amount but the amount may adjust for the limited purpose of covering the amount of excess concentration receivables arising in the trust accounts from time to time.

- It is true that, in all three cases outlined above, losses allocated to, or absorbed by, the *pari passu* seller's interest reduce the amount of the seller's interest. Notably, however, in virtually every case, once the seller's interest falls below a required minimum level, the seller is required by the governing program documents to transfer receivables arising in additional accounts to the master trust, thereby replenishing the trust assets and, in turn, the seller's interest.[4]

- This obligation to replenish the trust assets and, in turn, the seller's interest represents once again a fundamental difference from the forms of horizontal risk retention envisioned under the proposed rule, and the seller's obligation to transfer receivables arising in additional accounts operates as yet another significant mechanism that aligns the interests of the securitizer with those of investors.

- We request, therefore, that the definition of seller's interest be revised to provide that the seller's interest be *pari passu* with or subordinated to each series of investor interests with respect to the allocation of collections and losses.[5]

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[4] By contrast, losses absorbed by a series-level subordinated seller's interest reduce the amount of such seller's interest but the seller has no corresponding obligation to add new receivables to the master trust or otherwise replenish such seller's interest.

[5] If this request is not implemented in the final rule, then, as requested on slide 3 in our 12/16/13 slide deck, the definition should instead be revised to require the seller's interest to be *pari passu* with respect to allocations of collections only during revolving periods.