



Application of Credit Risk Retention Rule to Revolving Master Trusts

December 16, 2013

Credit Risk Retention and Revolving Master Trusts: Introduction

- We appreciate the changes that the Joint Regulators have made to better align the re-proposed rule with market practice, but more changes are necessary to create workable risk retention options for master trusts.
- Most importantly, as currently proposed, the seller's interest form of risk retention cannot be utilized by any master trust currently in the market.
- In addition, there is a substantial segment of the revolving master trust market – most notably, floorplan securitizations – that do not currently incorporate a *pari passu* seller's interest as a significant structural feature and, therefore, do not expect to utilize the seller's interest option as their primary form of risk retention.
- It is critical, therefore, that (i) the seller's interest option be revised to better align with market practice and (ii) there be a workable horizontal interest option for revolving master trusts.
- Today, we will highlight some of the most important changes that are needed, beginning with certain modest changes to the rule that will make it significantly more workable for major segments of the master trust market.

Modest Changes to Make the Rule Significantly More Workable

1. Seller's Interest Form of Risk Retention: Pari Passu Seller's Interest

The proposed definition of “seller’s interest” contemplates an interest that is *pari passu* to each series of investor interests with respect to the allocation of collections and loss amounts *prior to an early amortization event*.

- In virtually every case, allocations of collections between the investor interests and the seller’s interest are *pari passu* only during revolving periods.
- During other periods, including scheduled principal accumulation or scheduled principal amortization periods, virtually all master trusts fix the allocation of principal collections to the relevant investor interests at the higher levels applicable before principal payments begin.¹
- This fixing of allocations of principal collections to the investor interests provides for the orderly and timely payment of the investor interests, by deferring a full allocation of collections to the seller’s interest when a series, class or tranche of investor interests is in any form of principal accumulation or principal amortization period.
- **Requested Action:** We request, therefore, that any requirement in the final rule that the seller’s interest be *pari passu* to each series of investor interests be modified to require the seller’s interest to be *pari passu* with respect to allocations of collections only during revolving periods.

¹ By comparison, the allocation of losses between the investor interests and the seller’s interest remains pro rata at all times.

2. Seller's Interest Form of Risk Retention: Subordinated Seller's Interest

The Joint Regulators are also considering whether they should make additional provisions for subordinated seller's interests.

- The seller's interest in virtually every master trust features some form of subordination to the investor interests.
- By fixing the allocation of principal collections to the investor interests following a revolving period (as described earlier), the seller's interest becomes subordinated to investor interests.
- In some revolving master trust transactions, collections allocable to the seller's interest may first be used to cover shortfalls, if any, remaining after application of collections allocable to the investor interests, representing a form of credit subordination of the seller's interest to investor interests.
- There are, however, variations in the extent of such subordination, depending on investor preferences and ratings criteria. In some cases, collections allocable to the seller's interest may be made available to cover only shortfalls in interest or principal; in other cases, they may cover shortfalls in both interest and principal; and, in still other cases, they may absorb losses allocated to investor interests.
- Moreover, these forms of subordination are typically limited to collections allocable to the seller's interest in the current distribution period (*i.e.*, prior-period collections distributed to the seller are not available to the investor interests in subsequent periods).

2. Seller's Interest Form of Risk Retention: Subordinated Seller's Interest (cont'd)

- In each of the cases outlined above, these allocation mechanisms provide for the orderly and timely payment of the investor interests, and the seller's interest continues to represent an undivided interest in the securitized receivables that exposes the holder to a proportional or greater share of the credit risk of those receivables as compared with the share borne by the investor interests.
- We believe the seller's interest form of risk retention should give credit for all such forms of subordinated seller's interest on the same basis.
- **Requested Action:** We request, therefore, that the definition of seller's interest be revised to require the seller's interest to be *pari passu* with or subordinated to each series of investor interests with respect to the allocation of collections and losses.²

² If our request to give credit for all forms of subordinated seller's interests on the same basis is not implemented in the final rule, then, as requested earlier, 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.

3. Special Horizontal Risk Retention Option for Revolving Master Trusts: Reference to “Principal Due”

Clause (3) of the special horizontal interest option for master trusts in § __.5(f) requires the horizontal interest’s claim to any part of the series’ share of the interest and fee cash flows for any interest payment date to be subordinated to “all accrued and payable interest *and principal due* on the payment date to more senior ABS interests.

➤ The reference in clause (3) to “principal due” would preclude virtually any subordinated interest from qualifying for the special horizontal interest option.

➤ In the great majority of master trust structures, interest and fee cash flows are applied to pay interest due, to pay servicing and trustee fees, and to cover loss amounts allocated to the investor interests, but may not otherwise be available to make any principal payments due.

➤ Instead, principal cash flows are applied to pay principal due on the investor interests.

➤ In addition, the requirement that the horizontal interest have the most subordinated claim to principal repayment cash flow is already addressed in clause (4) of § __.5(f).

➤ **Requested Action:** We believe, therefore, that the reference to “principal due” should be deleted in clause (3), which would also conform to the description of clause (3) that appears in the Supplementary Information.

Other Important Changes to Make the Rule More Workable Across the Master Trust Market

4. Standard Horizontal Risk Retention Option: Not Viable for Revolving Master Trusts

- Master trusts cannot comply with the requirements of the standard horizontal risk retention option in § __.4.
- The comparison of the closing date projected cash flow rate to the closing date projected principal repayment rate does not work for master trusts or any revolving structure.
- During revolving periods, principal collections are reinvested and no principal payments are made, while finance charge collections are applied, interest payments are made, and excess spread is distributed. As a result, no residual or interest-bearing horizontal interest could satisfy the required projected cash flow comparison.
- In the case of de-linked master trusts, subordinated tranches of a series may be paid principal prior to later-maturing more senior tranches of the same series. As a result, it is unlikely that such an interest could satisfy the required projected cash flow comparison.
- In addition, as detailed in SFIG's comment letter, the difficulties with the projection and certification requirements for eligible horizontal residual interests (EHRIs) are particularly acute for master trust sponsors, since a sponsor cannot know the composition of its assets and liabilities on any future date.

4. Standard Horizontal Risk Retention Option: Not Viable for Revolving Master Trusts (cont'd)

- Clause (2) of the EHRI definition requires that shortfalls reduce amounts paid to the EHRI before amounts paid to any other ABS interest are affected. Under the proposed rule, the sponsor's residual interest in excess spread appears to be an ABS interest and, with its first-loss position, it appears that it would need to qualify as an EHRI and satisfy the other requirements applicable to EHRIs in § __.4 before any other subordinated tranche or class of ABS interests could qualify. And yet, as acknowledged by the Joint Regulators, such a residual interest in excess spread cannot satisfy these requirements.
- In addition, as drafted, the EHRI definition does not contemplate or accommodate series-level allocations of collections and related distributions.
- **Requested Action:** The special horizontal risk retention option for master trusts should be revised as set forth in SFIG's comment letter to accommodate the additional forms of horizontal risk retention already used in the market.

5. Special Horizontal Risk Retention Option for Master Trusts: More Forms Already Used in the Market Should Qualify

- Clause (3) in § __.5 requires the qualifying horizontal interest's claim to any part of the series' share of the interest and fee cash flows for any interest payment period (i) to be subordinated to interest and principal due on the payment date to more senior ABS interests in the series and (ii) to be further reduced by the series share of losses.
- Depending on how the Joint Regulators intended that clause (3) be construed, as drafted, it may preclude most interest-bearing subordinated investor interests retained by the sponsor or its majority-owned affiliates from qualifying for the special horizontal interest option.³
- As drafted, the special horizontal interest option would not give credit for horizontal interests issued in one series that are subordinate to investor interests issued in one or more other series, including horizontal interests issued by a legacy trust that are subordinate to investor interests issued by the related issuance trust.
- Clause (4) in § __.5(f), which requires the qualifying horizontal interest to have the "most subordinated claim to any part of the series' share of the principal repayment cash flows" needs to be clarified for de-linked master trusts.
- **Requested Action:** The special horizontal risk retention option should be revised as set forth in SFIG's comment letter to accommodate these additional forms of horizontal risk retention already used in the market.

³ It is unclear whether the Joint Regulators intended that clause (3) prohibit a horizontal interest from receiving any share of interest and fee cash flows before using those cash flows to cover current loss amounts allocated to the series.

6. Proportional Credit for Retained Horizontal Interests Based on the Relative Size of Each Series

- Credit for retained horizontal interests is available to master trusts only if the sponsor maintains a specified amount of horizontal risk in *every* series issued by the master trust, but we believe the desired alignment of interests between the sponsor and other ABS investors can be achieved regardless of whether the sponsor retains the same percentage interest in each series.
- Each series issued by a master trust is supported by one or more common pools of collateral, and so the fact that a sponsor retains exposure to that collateral through one series versus another should be irrelevant, so long as the aggregate exposure, based on the relative size of each series, represents 5% of the total principal amount of the related outstanding investor interests.
- **Requested Action:** We request that sponsors receive proportional credit for horizontal interests retained based on the relative size of each series, regardless of whether the sponsor holds a minimum percentage of each series.

7. Valuation of Horizontal Interests in Master Trusts

The Joint Regulators propose that the seller's interest be measured on a face-value basis – because sponsors of master trusts do not issue senior interest-only or premium bonds in their ABS structures – but posit that a subordinated seller's interest or a horizontal interest in a master trust be measured on a fair-value basis.

- As noted by the Joint Regulators, “a fair value determination [for seller's interests] would create additional complexity and costs, especially given the frequency of the measurements required.”
- A fair-value determination for subordinated seller's interests and horizontal interests would likewise be burdensome, especially if master trust sponsors are required to perform such calculations monthly on every seller's interest measurement date, or to re-value previously issued ABS interests on each closing date.
- Moreover, for a master trust that does not monetize excess spread, a retained interest in 5% of the securitized assets represents at least 5% of the credit risk of those assets regardless of whether the retained interest is *pari passu* or subordinate to other ABS interests.
- The fair value of a subordinated seller's interest or a subordinated horizontal interest will reflect the increased potential for losses, and may reflect that the subordinated interest will be paid at a later date than senior ABS interests, but this does not reduce the sponsor's “skin-in-the-game.”

7. Valuation of Horizontal Interests in Master Trusts (cont'd)

- **Requested Action:** We believe that a face-value measurement should be the valuation standard for all forms of the seller's interest as well as for retained investor ABS interests, so long as the master trust does not issue premium or interest-only bonds and does not otherwise monetize excess spread, and the sponsor or a majority-owned affiliate retains the residual interest in excess spread.
- We believe that 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 that most sponsors will elect not to claim credit for such interests. We are generally comfortable with this result, so long as the final rule allows sponsors to disregard their residual interest in excess spread and still receive credit for other horizontal interests that it retains.

8. Measurement Dates for Seller's Interest and Combined Risk Retention Options

- We generally believe that it is appropriate to measure the seller's interest monthly and that such a requirement would not be burdensome given market practice and the ease of the calculation.
- For purposes of the option to combine the seller's interest with series-level horizontal interests, it is unclear whether the Joint Regulators intended sponsors to calculate the fair value of each horizontal interest on a monthly basis.
- If our request to measure horizontal interests on a face-value basis is adopted, it should be possible for a sponsor to recalculate the offset to the seller's interest with relative ease on a monthly basis.
- If, on the other hand, a sponsor were required to measure horizontal interests on a fair-value basis, requiring a recalculation on a monthly basis would be extremely burdensome and would be inconsistent with the requirements for EHRIs under the standard risk retention option.
- In addition, a sponsor should not be required to increase its risk retention for a series to the extent the horizontal interest declines in value (whether face value or fair value) after the closing date for that series, as this would effectively require the sponsor to hold a greater than 5% retained interest in the securitized assets.
- **Requested Action:** If our request to measure horizontal interests on a face-value basis is not adopted, and if the Joint Regulators determine that a re-valuation of horizontal 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.⁴

4 The “invested amount” of an ABS interest refers to its outstanding principal amount as reduced by write-downs for losses.