

## MEMORANDUM

**TO:** File No. S7-14-11

**FROM:** Arthur Sandel  
Special Counsel  
Office of Structured Finance  
Division of Corporation Finance  
U.S. Securities and Exchange Commission

**RE:** Meeting with SFIG auto securitization representatives

**DATE:** December 12, 2013

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On December 6, 2013, Katherine Hsu, Arthur Sandel, David Beaning and Lulu Cheng of the Division of Corporation Finance and Sean Wilkoff and Igor Kozhanov of the Division of Economic and Risk Analysis participated in a meeting with the following auto securitization representatives of the Structured Finance Industry Group, Inc. (“SFIG”): Richard Johns and Sairah Burki of SFIG; Phoebe Moreo of Deloitte & Touche LLP; Bradley Brown and Matt St. Charles of Ally Financial Inc.; Stuart Litwin of Mayer Brown LLP; Jon-Claude Zucconi of Credit Suisse (by telephone); Sam Smith, Dan Mellett and Dave Dickenson of Ford Motor Company (by telephone); and Armando Falcon of Falcon Capital Advisors (by telephone).

The following staff of other federal regulators also participated: James Basham and Kevin Korzeniewski of the OCC; Kathy Russo, Phil Sloan, Suzanne Clair, Tom Lyons (by telephone) and Gene Pocase of the FDIC; Adam Ashcraft of the Federal Reserve Bank of New York (by telephone); and Donald Gabbai, Sean Healey, David Alexander, Matthew Suntag and Ann McKeehan of the Federal Reserve Board (by telephone).

The participants discussed topics related to the Commission’s August 28, 2013 joint proposed rules regarding credit risk retention. Handouts are attached to this memo.

Attachment



# Risk Retention Re-Proposal

December 6, 2013

# Importance of this meeting

- Issues discussed today affect the entire securitization market
- Attendees at this meeting include representatives of auto ABS issuers to emphasize the importance of ABS to:
  - Manufacturers
  - Dealers
  - Jobs
  - Our US and global economy

# Agenda

- Representative Sample
- Eligible Horizontal Residual Interest (EHRI)
  - Key Issues of the Fair Value Approach
  - Limitations on EHRI Distributions
  - Revolving Transactions – Self Adjusting Approach
  - Simplified Approach for Simplified Structures
  - Relief for Truly Private Transactions
- Qualifying Auto Loan Exemption
- Floorplan
- Other Points

# Representative Sample

- FDIC Safe Harbor has permitted representative sample method
- Banks and others have used representative sample approach for last few years
  - It's working, and these sponsors have found this alternative to be cost-effective
- Coordination with CRD 122a
- Necessary for many accounting sale transactions
- This method is extremely important to many of our members
  - Willing to go beyond Safe Harbor requirements if necessary to get regulators comfortable with approach
- Participation Interests also provide a simple and inexpensive method
  - We'd like an opportunity to discuss this in more detail later

# EHRI – Key Issues of the Fair Value Approach

- Significant improvement over original proposal, but still has issues that require work
- Risks from disclosure of expected loss and other projections
  - Overreliance by investors on sponsor loss projections and fair value calculations
  - If you're doing a good job of predicting, you'll underestimate losses half the time
    - Reputational risk/investor perceptions if some of your deals are “underperforming”
    - Will result in systematic overstatement of losses, thereby reducing the fair value
  - Legislative intent of Risk Retention was to align issuer and investor interests, not create these issues
- Complexity and cost for sponsors with consolidated SPEs
  - Vast majority of auto ABS deals are on balance sheet
- Range of values under GAAP, not a single value
- “Chicken and egg” timing problem.
  - Structure of Securities to be sold and waterfall must be determined before the offering
  - Don't know fair value until pricing
  - Could have different pricing dates for senior and subordinated securities
- Does not work for revolving transactions
- Liability risks may require a Safe Harbor for these projections

# EHRI - Limitations on EHRI Distributions

- Apples vs oranges
  - Comparison of all cash flows with just principal repayment
  - Fair value/discounted dollars (CDPCFR) vs nominal dollars (CDPPRR)
- Problematic for many established structures:
  - Simple, proven, plain vanilla auto ABS structures that maintain substantially more than 5% risk retention over their lives
  - Structures with significant excess spread
  - Issuers who only issue very senior (i.e., AAA and A) bonds with much more than 5% overcollateralization
- Timing: Calculations can't be made at the time bonds are structured (before marketing the transaction)
- Revolving transactions with reinvestment of principal
- Better to use a direct measure rather than limit distributions

# EHRI - Revolving Transactions - Self Adjusting Approach

- Most revolving transactions are not in master trusts, including warehouse facilities
- Re-proposal does not offer a risk retention option that works for these common structures
  - These structures are used extensively by auto finance companies and are an important component of liquidity for them
- Can't project future cash flows without knowing the assets to be in the deal in the future.
- Commitments typically get renewed, so you don't know when amortization will begin
- Proposed Self Adjusting Approach to EHRI:
  - Testing at each time additional assets are added (or incremental amounts are invested)
  - At each testing date, the residual interest must be at least 5% of the total amount of all ABS interests (or securitized pool balance)
  - No distributions to residual holder if it would reduce the residual interest below 5%
  - Testing to be done as if no future assets are added and that the deal amortizes thereafter
  - Intended to mirror what really happens in revolving transactions

# EHRI - Simplified Approach for Simple Structures

- Possible conditions were listed in our letter:
  - ABS principal amount sold to third parties  $< 95\%$  of securitized pool balance
  - Asset WAC (or discount rate)  $>$  ABS WAC
  - ABS are just traditional interest bearing securities (i.e., no I/Os)
  - Residual interest is a traditional equity interest
- Very important to our members
  - Many sponsors intend to structure their deals to be sufficiently “obvious” to avoid disadvantages of Fair Value
  - Many are willing to hold more than 5% for a simpler alternative

# EHRI - Relief for Truly Private Transactions

- Some transactions involve investors negotiating their own note purchase agreement
  - No offering memo
  - Due diligence
- In these transactions, a substantial expansion of disclosure would be required at unnecessary cost
- Likely result is that these transactions would not be structured as securitizations
  - Issuer would not get the benefit of a lower cost of funds
  - Investors might not get benefit of bankruptcy-remote structure

# Qualifying Auto Loan Exemption

- Some requirements are inconsistent with prime auto loan origination:
  - Down Payment
  - Debt-to-Income
  - Data Verification
- Blended Pools
- We'd be happy to have a separate meeting to discuss the details of the QAL exemption

# Floorplan

- Critical to auto issuers to have a workable means of risk retention for floorplan transactions
  - Floorplan master trusts typically have a seller's interest that is not *pari passu*
  - Special Horizontal Interest requires a minor change or clarification to be an option for established floorplan master trusts
  - We don't intend to discuss in detail today, but wish to emphasize the importance of this issue to our members
- Floorplan transactions are important to auto finance companies, as well as to the manufacturers, dealers and the economy

# Other General Issues

- Certification Requirements

- Dodd-Frank provides for certification only for ABS *“collateralized exclusively by”* QRMs
  - Certification should be required only for RMBS
  - For RMBS transactions, should be required only for QRM transactions exempt from standard risk retention
- Provide only to SEC and bank regulators
  - Rule 193 and Regulation AB Item 1111(a)(7) are already required
  - Rule 15Ga-1 requires reporting of repurchases
  - Repurchases are already required for inclusion of non-qualifying assets
- Retain certification for no longer than five years
  - Consistent with SEC retention requirements for signature pages

- Need for a No-Action Letter/Interpretive Process

- Innovation in the ABS market will necessarily result in new structures and related interpretive issues
- Very difficult to get six agencies to convene and focus on individual transactions